Task Force on the Future of the Canadian Financial Services Sector

September 1998

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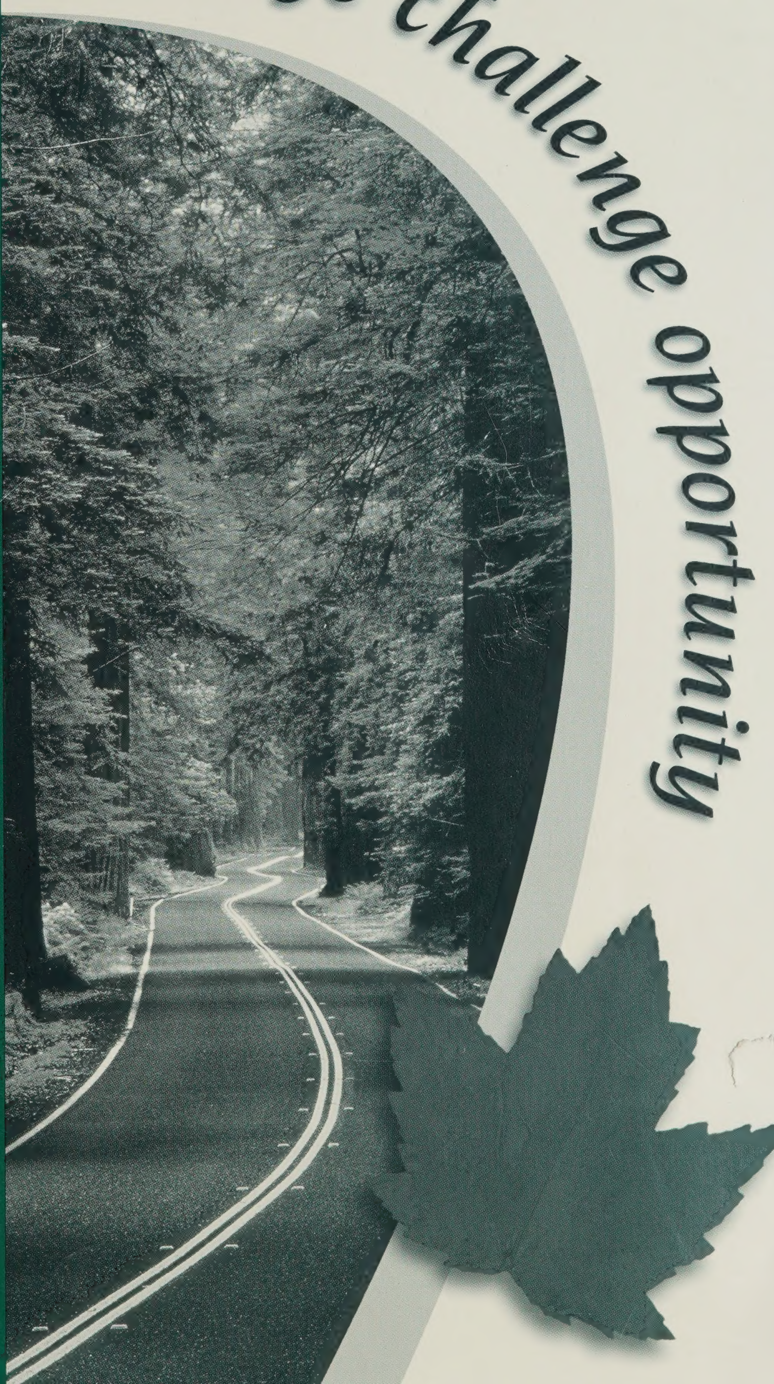

Improving the Regulatory Framework

Background Paper #5

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Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa K1A 0G5

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Chapter 1

Prudential Regulation of Financial Services: An Overview

Introduction

This background paper is concerned with improving the structure of prudential regulation of financial institutions. By and large, Canada has a modern framework for prudential regulation that works well. Our structure has been kept up to date and we have been a world leader in aligning our regulatory structure with the evolving structure of the industry. It is nevertheless timely, in light of the changes continuing to take place in the sector, to examine whether further measures are necessary to maintain a first-class regulatory system.

This chapter describes the evolution of the existing framework for the prudential regulation of financial institutions. Subsequent chapters address:

- the mandate and governance of the Office of the Superintendent of Financial Institutions (OSFI); the balance between safety and soundness and competition; the streamlining of regulation, including harmonization among OSFI and its provincial counterparts and between OSFI and the Canada Deposit Insurance Corporation (CDIC), and simplification of some of OSFI's processes (Chapter 2);
- the lack of symmetry between the compensation plans that apply to deposit-taking institutions (DTIs) and life insurers (Chapter 3);
- the absence of a regulatory framework to deal with entry into the Canadian financial services sector by foreign firms that are not physically present in Canada (Chapter 4); and
- international supervisory standards and coordination (Chapter 5).

Why Regulate?

The financial services industry is subject to *market conduct regulation,* which is designed to protect customers engaging in specific transactions. It is also subject to *prudential regulation,* which is designed to maintain the soundness of financial institutions and the safety of the financial system as a whole.

Market Conduct Regulation

Intervention in the normal course of commerce through market conduct regulation is required for consumer protection. Many financial transactions, such as the purchase of life insurance, are complex and infrequently undertaken. Accordingly, market conduct regulation typically takes the form of educational and licensing requirements for insurance brokers and agents and securities dealers, and standardized language and disclosure in contracts.

Deposit-taking institutions have traditionally been considered the least in need of market conduct regulation. Placing money on deposit has historically been simple and easily understood and, for the most part, carried out directly with the financial institution concerned. However, as deposit-taking institutions increasingly offer financial advice and more complex savings products such as mutual funds, their market conduct takes on more importance.

Background Paper #3, *Empowering Consumers,* reviews market conduct regulation in more detail and sets out Task Force conclusions and proposals in this area.

Prudential Regulation

Prudential regulation is intended to protect unsophisticated consumers and to minimize systemic risk. It is difficult for most consumers to assess accurately the risk of the financial institutions with which they deal. Prudential regulation substitutes collective oversight by governments for individual oversight.

The case for prudential regulation to ensure the safety and soundness of the financial system as a whole is based in part on the fact that the safety and soundness of individual institutions depends in some measure on the soundness of other institutions. It is generally accepted that a "run" on one troubled institution may, in some circumstances, result in runs on other, sound financial institutions. This in turn may destabilize the whole financial system, including the settlement arrangements of the payments system and the real economy as well.

The systemic rationale for prudential regulation applies only to institutions which could threaten the stability of the financial system as a whole. Traditionally these institutions have been the banks and trusts. However, the expansion of the business lines of the life insurance industry, along with the ongoing evolution of some of its products into forms very similar to those offered by banks, has increased the significance of life insurance companies to the stability of the overall financial system.

Prudential regulation also reduces the risks to the deposit insurance system by both monitoring insured institutions and protecting against systemic breakdown that could result in substantial taxpayer exposure.

Who Regulates?

The Constitutional Division of Federal and Provincial Jurisdiction

The constitutional division of jurisdiction between the federal and provincial governments is reflected in the division of the powers to regulate financial institutions. These institutions include banks, trust and loan companies, insurance companies, securities dealers, credit unions and caisses populaires. Some of these institutions are regulated exclusively by the federal government, some exclusively by the provinces and some by both. Other providers of financial services such as commercial leasing companies are not regulated as financial institutions at all. The line between the regulated and unregulated depends on whether certain "core" activities are carried on: fiduciary activities, underwriting insurance, dealing in securities, deposit-taking, and use of the word "bank" in a corporate name and the word "banking" to describe a business are all activities which may be undertaken only through a regulated financial institution.

The Constitution Act, 1867 gives the federal government exclusive jurisdiction over banking and the incorporation of banks. While Parliament has never seen fit to define "banking," it has regulated banks since 1867. The first permanent Bank Act came into force in 1870. Since 1880, the Bank Act has contained a prohibition barring any person, corporation or entity other than a chartered bank from using the words "bank," "banker" or "banking" in its name or to describe a business carried on in Canada.[1]

The provinces, on the other hand, have no explicit regulatory power over financial institutions. Provincial jurisdiction in this matter flows implicitly from three other heads of power set out in the Constitution Act, 1867. These are "The Incorporation of Companies with Provincial Objects," "Property and Civil Rights in the Province," and "Generally all Matters of a merely local or private Nature in the Province." The power to incorporate institutions is shared with the federal government, which retains the residual power to incorporate where the objects of the company in question are not exclusively provincial.

Federal Regulatory Jurisdiction

The outcome of this constitutional division of powers is that the federal government has jurisdiction over banks, which are among those financial institutions that are the least subject to overlapping regulatory regimes.

Similarly, the Credit Union Central of Canada (CUCC), which acts as the national umbrella organization for the provincial central cooperative credit

[1] For the current provision, see s-s. 564(2) of the Bank Act, S.C. 1991, c. 46. There are limited exceptions for organizations which do not carry on financial services, for example "Food Bank" and "Blood Bank."

associations, is incorporated federally under the Cooperative Credit Associations Act and subject to federal jurisdiction.

Provincial Regulatory Jurisdiction

Each province has exclusive jurisdiction over local credit unions and caisses populaires incorporated in that province, since the powers of those institutions do not usually extend beyond the borders of their province of incorporation (and are usually limited to much smaller geographic regions).[2] Each province also has exclusive jurisdiction over trust, loan and insurance companies incorporated by the province if the company in question does not operate beyond the borders of its province of incorporation. Securities dealers, although they may be incorporated at the federal level, are subject to provincial regulation.[3]

Shared Jurisdiction

Trust, loan and insurance companies can be incorporated at the federal level, pursuant to the residual incorporation power.[4] However, when the incorporation power is exercised at the federal level, the provinces retain jurisdiction as well, pursuant to their property and civil rights power. This enables the provinces to regulate such matters as market conduct and consumer protection. As a result, federally incorporated financial institutions, other than banks, are subject not only to federal regulation but also to regulation in each province in which they do business.

The central cooperative credit associations are also subject to shared federal-provincial jurisdiction. The centrals are incorporated provincially and act as umbrella organizations for the local credit unions in each province. However, pursuant to the federal Cooperative Credit Associations Act, these provincial centrals may opt in under federal regulation, and six of them have done so.

Duplicative regulation also arises from the fact that provincially regulated financial institutions, other than credit unions, usually do business in more than one province. Given the lack of harmonization among provincial laws and provincial regulatory regimes, such financial institutions are subject to the

[2] Some credit union legislation provides for the power to operate interprovincially, but this power has not yet been exercised. There are three federations of caisses populaires outside Quebec that are contractually affiliated with Desjardins.

[3] In the case of securities dealers owned by banks and other federally incorporated financial institutions, an understanding was reached between the federal and Ontario governments in April 1987 known as the Hockin-Kwinter Accord (named for the then Minister of State (Finance) for Canada and the then Minister of Financial Institutions for the Province of Ontario). The accord allocated federal jurisdiction to the limited securities activities of federally regulated financial institutions, and confirmed that other main-line securities activities, such as equity issues, would be undertaken through a subsidiary regulated at the provincial level.

[4] The incorporation power, whether exercised at the federal or provincial level, includes corporate structure, the powers that such corporations may exercise and capital adequacy.

applicable regulatory regime in each province in which they do business (which, if they operate across Canada, can amount to 10 provincial and two territorial regimes).

The result is that, in addition to the federal Office of the Superintendent of Financial Institutions (OSFI), each province has the equivalent of a superintendent of deposit-taking institutions, a superintendent of insurance and a securities commission, together with an underlying supervisory and administrative organization.

Exhibit 1.1 contains information about the number of banks, trust and loan companies, life insurance companies, and property and casualty insurance companies in Canada, and whether they are incorporated federally or provincially. Exhibit 1.2 shows the different federal and provincial regulators responsible for the prudential regulation of the same institutions.

Exhibit 1.1

Number and Incorporation of Institutions

It should be noted that there may be some double counting of provincial companies as some companies have multiple provincial registrations.

	Banks	Trust & loan	Life insurance	Property & casualty
Federal	58	59	129	220
Provincial (including Ontario, Quebec, and BC)	–	25	25	74
Ontario	–	6	5	18
Quebec	–	5	16	23
BC	–	6	–	10

Sources: 1997 annual reports of insurance and loan and trust companies (Quebec), BC Financial Institutions Web page, OSFI Web page, telephone conversations with officials of various provincial government departments.

Exhibit 1.2

Federal and Provincial Regulators of Banks and Trust, Loan and Insurance Companies

	Prudential Supervisors		Banks	T&L	Life	P&C
Canada	OSFI	Superintendent of Financial Institutions	•	•	•	•
Alberta	Treasury Department	Superintendent, Insurance			•	•
		Director, Financial Institutions		•		
BC	Financial Institutions Commission	Superintendent		•	•	•
Manitoba	Department of Consumer and Corporate Affairs	Superintendent of Insurance			•	•
		Director, Trust and Loans		•		
New Brunswick	Department of Justice	Superintendent of Insurance			•	•
		Director, Examination of Financial Institutions		•		
Newfoundland	Department of Government Services and Lands, Commercial and Corporate Affairs Branch	Director, Deposit-Taking Institutions Division		•		
		Director, Insurance and Pensions Division			•	•
Nova Scotia	Department of Business and Consumer Affairs	Director of Financial Institutions		•		
		Superintendent of Insurance			•	•
Ontario	Financial Services Commission of Ontario	Superintendent of Financial Services		•	•	•
PEI	Department of Provincial Affairs and Attorney General	Superintendent of Insurance			•	•
Quebec	Inspector General of Financial Institutions	Inspector–General		•	•	•
Saskatchewan	Department of Justice	Superintendent of Insurance[1]		•	•	•

[1]Also responsible for deposit-taking institutions.

The Present Federal Regulatory Structure

OSFI is the primary supervisor of banks and other federally incorporated financial institutions. In addition, CDIC plays an indirect regulatory role, while the Department of Finance and the Bank of Canada are involved at the policy level. The Minister of Finance has the ultimate decision-making power in many important matters affecting financial institutions.[5] These matters include the incorporation of new financial institutions, changes in control and decisions to liquidate an institution.

OSFI

OSFI was established in 1987. It has responsibility for supervising all federally incorporated financial institutions. A more detailed description of OSFI, its structure, powers and mandate, is contained in Chapter 2 of this paper.

CDIC

CDIC is a Crown corporation established in 1967 by the Canada Deposit Insurance Corporation Act (the CDIC Act).[6] It insures deposits made by members of the public with banks and other deposit-taking institutions, both federal and provincial.[7] All deposit-taking institutions that are members pay premiums to cover CDIC's insurance obligations, although those obligations are guaranteed by the Government of Canada since CDIC is a crown corporation. In addition, CDIC has the power to borrow, if need arises, both from the Consolidated Revenue Fund (CRF)[8] and from the private sector; any such loans are ultimately repaid by the premiums collected from member institutions. CDIC is described in more detail in Chapter 3 of this paper.

The Bank of Canada

The Bank of Canada was established in 1934 and was originally a privately owned corporation. Since 1938 the Bank has been owned by the federal government, and the Bank's annual profits are credited to the CRF. The Bank does not operate as an ordinary private bank. It does not, for instance, take deposits from the general public. It acts as the federal government's banker and fiscal agent, and has the sole power to issue Canadian bank notes.

[5] The Governor-in-Council has the ultimate decision-making power in matters relating to the entry and activities of foreign banks. See Chapter 2 of this paper, p. 46.

[6] R.S.C. 1985, c. C-3, as amended ("CDIC Act").

[7] Deposits have no priority over unsecured creditors (with the exception of the deposits of trust companies, which are taken in the form of "guaranteed trust money" and as such rank ahead of unsecured creditors).

[8] The Consolidated Revenue Fund is the aggregate of all public monies that are on deposit at the credit of the Receiver General; Financial Administration Act, R.S.C. 1985, c. F-11, section 2.

The mandate of the Bank is set out in the preamble to the Bank of Canada Act[9] and is as follows:

- to regulate the supply of credit and currency in the best interests of the Canadian economy;
- to control and protect the value of the Canadian dollar;
- to minimize fluctuations in the general level of production, trade, prices and employment; and
- to promote the economic and financial well-being of the nation.

The Bank makes advances to chartered banks and to the federal and provincial governments and sets the Bank Rate, which is the minimum rate at which the Bank will make such advances. The Bank also makes secured loans to financial institutions in the form of "ordinary" loans, which cover overnight liquidity deficits. As lender of last resort it makes "extraordinary" loans to otherwise-solvent institutions that are encountering longer-term cash flow problems.

The Bank is involved in the payment-clearing and settlement process through which the claims generated by cheques and, increasingly, electronic debits drawn on Canadian financial institutions are settled. The settlement takes place on a daily basis by a transfer of funds between accounts held at the Bank of Canada by the financial institutions which are direct clearers in the system. The Payment Clearing and Settlement Act of 1996 gave the Bank the authority to designate major clearing and settlement systems that appear to involve systemic risk, as well as the formal and explicit responsibility for regulatory oversight of such systems and the power to guarantee settlement.[10] Pursuant to this power, the Bank guarantees the settlement of the Large-Value Transfer System (LVTS), which is scheduled to become operational in 1998.[11]

The Bank has the power to require OSFI to inspect for a specified purpose any financial institution for which OSFI has responsibility.[12] Such financial institutions are required to provide the Bank with whatever information it may require at any time.[13]

[9] R.S.C. 1985, c. B-3, as amended.

[10] Further details on the payments system, and Task Force conclusions and proposals, are presented in Background Paper #2, *Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition,* Chapter. 4.

[11] The LVTS is an electronic credit transfer system for large-value payments that features real-time multilateral net accounting for settlement balances with certainty of final settlement on an item-by-item basis in real time, but with deferred settlement on the accounts of the direct participating groups at the Bank of Canada. The system is based on the provision of collateral with the Bank of Canada guaranteeing any residual amount of required settlement balances if there is a shortfall.

[12] Bank of Canada Act, section 22.1.

[13] Ibid., section 24.1.

Department of Finance

The Department of Finance[14] is responsible for informing and advising the government about the broad economic and financial affairs of the nation. This includes monitoring financial markets, preparing the federal budget, preparing changes to tax and tariff legislation, managing the federal debt program, and acting as Canada's representative at international financial organizations such as the World Bank and the International Monetary Fund (IMF).

The Minister of Finance is responsible for the Department, which is administered by a Deputy Minister. The Minister in turn reports to Parliament and is also responsible for reporting to Parliament on the activities of the Bank of Canada, CDIC and OSFI.

The Financial Sector Division of the Department "develops and evaluates policies on the regulatory framework applicable to Canada's financial institutions."[15] Within the Financial Sector Division are four sections dealing, respectively, with financial institutions, policy development, intergovernmental relations and strategic analysis.

Evolution of Prudential Regulation

In recent years there have been two major changes in the regulation of Canadian financial services at the federal level. The first was the establishment of OSFI in 1987 to regulate all federal financial institutions, both deposit-taking institutions and insurance companies. The establishment of OSFI was accelerated by the *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (the "Estey Report").[16] The second was an overhaul and modernization of the federal legislation governing financial institutions themselves. Much of this modernization stemmed from the government's 1985 Green Paper[17] and 1986 Blue Paper,[18] although enabling legislation was not passed until 1991.

The Convergence of the Four Pillars

The Canadian financial services sector was traditionally composed of four "pillars" – banks, securities dealers, insurance companies and trust companies. Regulation was carried out along institutional lines, with functional and

[14] Material on the Department of Finance is taken from the Department of Finance publication *Finance Canada: Structure and Role* (Ottawa, January 1998).

[15] Ibid., p. 13.

[16] Hon. Willard Z. Estey, *Report of the Inquiry into the Collapse of the CCB and Northland Bank*, August 1986.

[17] Department of Finance, *The Regulation of Canadian Financial Institutions* (Ottawa, April 1985).

[18] Department of Finance, *New Directions for the Financial Services Sector* (Ottawa, December 1986).

investment limitations preserving the distinction among the pillars. Banks could not engage in the securities or insurance business, and could not undertake fiduciary activities; insurance companies could not accept deposits and had very limited investment powers, as did trust companies. Cross-pillar ownership was not generally permitted.[19]

The federal government was aware that changes in these traditional distinctions were taking place in other countries, and it published two discussion papers during the 1980s, both of which reviewed the financial sector. The first, published in 1985 under the title *The Regulation of Canadian Financial Institutions*, is discussed below under the heading "The Green Paper." This was followed in 1986 by the Blue Paper entitled *New Directions for the Financial Sector.* The Blue Paper acknowledged the challenge of fostering world-class financial institutions and set the stage for removing the institutional barriers among the four pillars.

The actual dissolving of the institutional barriers began in 1987, when the federal legislation was amended to allow ownership of securities firms by banks and federal trust, loan and insurance companies. Although insurance and trust companies were put on an equal footing with banks in this regard, only the banks availed themselves of the new opportunity. The outcome has been that virtually all the major Canadian securities firms have now been bought by banks.

This initial relaxation of the structural rules was followed by a complete overhaul of the federal financial institution legislation. The changes came into force in June 1992. Banks, insurance companies and trust companies were given expanded, overlapping and almost identical business and investment powers, together with the ability to own all types of financial institutions as subsidiaries ("cross-pillar ownership"). Once again the initiative was taken by the banks. Almost all of the large, independent trust companies have been acquired by banks over the past few years.[20]

Certain "core" powers continue to be reserved along institutional lines. Only banks and trust and loan companies may take deposits. Trust companies are the only type of financial institution that may engage in the core trustee functions relating to individuals, such as acting as an executor, administrator or guardian, or as a tutor, curator or judicial adviser. Only insurance companies

[19] Prior to 1992, because of the way the rules were drafted, at least three insurance companies owned trust company subsidiaries through ownership of 30 percent of the shares of the trust company (which was the permitted amount), with subsidiaries of the insurance company owning all the other shares.

[20] The only exception is Canada Trust. It should be noted that many of the acquired trust companies were failing.

may underwrite insurance. Notwithstanding the reservation of these core functions, all federal financial institutions are now described as being in the business of "providing financial services."[21]

The Green and Blue Papers

The federal government's Green Paper entitled *The Regulation of Canadian Financial Institutions,* published in April 1985, proposed the consolidation of the trust and loan company supervisory functions (at that time undertaken by the Superintendent of Insurance) with the supervisory functions of the Office of the Inspector General of Banks. The House of Commons Standing Committee on Financial Institutions, after debating the Green Paper, went several steps further. The committee recommended the consolidation of the Office of the Inspector General of Banks, the Department of Insurance and CDIC into a single regulatory body that would perform the supervisory, regulatory and insurance functions in relation to banks, federal trust and loan companies, and federal insurance companies. The Senate Banking Committee, on the other hand, in its deliberations on the Green Paper, rejected the idea of one regulatory body and recommended the retention of the existing regulatory framework in its entirety.

The Blue Paper, *New Directions for the Financial Sector*, was published in December 1986. The main public policy challenges addressed by the Blue Paper were: seizing the opportunity provided by the internationalization of financial markets to foster world-class Canadian financial institutions; capturing for consumers the benefits of competition by dynamic financial institutions; protecting against self-dealing; and strengthening prudential practices. The Blue Paper laid down the framework for the creation of OSFI and the revisions to the federal financial institution legislation. Although these did not come into force until 1992, many of the principles set out in the Blue Paper remained intact, including the expanded business and investment powers and the self-dealing rules.

[21] Insurance Companies Act, S.C. 1991, c. 47, subsection 440(1); Trust and Loan Companies Act, S.C. 1991, c. 45, subsection 409(1). Banks remain in the "business of banking;" however, the business of banking is now described as including the provision of "any financial service"; Bank Act, subsection 409(2). The Insurance Companies Act does not even specifically state that insurance companies are in the business of insurance. The reservation of insurance underwriting to insurance companies stems from two other sources. The first is the fact that the order to commence and carry on business which every insurance company must obtain sets out the classes of insurance that the insurance company in question is authorized to underwrite. The second is the fact that the Bank Act and the Trust and Loan Companies Act severely restrict the insurance activities of banks and trust and loan companies.

The Estey Report

The inquiry into the cessation of operations of the Canadian Commercial Bank (CCB) and the Northland Bank[22] was established in September 1985 under the Honourable Willard Z. Estey, a justice of the Supreme Court of Canada. The "Estey Report" was published in August 1986.

CCB and Northland were two small banks with headquarters in western Canada, both of which had been in existence for approximately 10 years. Both banks were engaged in lending to mid-market commercial borrowers, funded in large part by the wholesale money market. A combination of imprudent lending practices, rapid growth, large loans to relatively few borrowers (many of whom were in the cyclical real estate and energy sectors) and excessive concentration in limited geographic areas led to their downfall.[23]

At the time, banks were subject to a tripartite regulatory system consisting of the Inspector General of Banks, the external auditors and the Minister of Finance. Various powers were vested in the Minister, including the powers to revoke the appointment of auditors, to require information, to authorize examinations, and to issue directives regarding capital adequacy and liquidity.

The Report identified flaws in the design of the regulatory system. Not the least of these was the fact that the authorization of the establishment of foreign bank subsidiaries in the form of Schedule B banks in 1980 had resulted in the establishment of approximately 60 new banks.[24] This development had not been accompanied by any "enlargement of the inspection system" or re-alignment of the system to accommodate the new banks. The Report stated:

> The government of the day somehow overlooked the evident need to make some adjustments to the [Bank] Act to accommodate the changing circumstances in banking and to study the inspection and regulation of banks in the light of these significant changes. In short, the adoption of a policy of expansion of the population of banks was not accompanied by a study of the complementary changes required in the supervisory system.[25]

The Estey Report commented on the absence of "the will to respond" to the warning signals that CCB and Northland were in financial trouble. This state of affairs was attributable primarily to the Inspector General of Banks, but also to the external auditors and the government.

[22] The two banks represented approximately 1 percent of the Canadian banking system "measured by assets, earnings or any other reasonable standard" (Estey Report, p. 1). In fact, Northland Bank was not placed in liquidation until January 1986, after the inquiry had commenced its proceedings.

[23] Ibid., p. 2.

[24] Schedule B banks are now called Schedule II banks.

[25] Estey Report, op. cit., p. 3.

As a result, the Estey Report recommended sweeping changes to the regulatory system applying to Canadian financial institutions. Among other things, the Report recommended that the functions of the Office of the Inspector General of Banks be combined with, and transferred to, an expanded CDIC. Although this recommendation was not acted upon, OSFI was established in 1987 by the OSFI Act.[26]

The Establishment of OSFI

OSFI was created through the amalgamation of the Office of the Inspector General of Banks and the Department of Insurance. Formerly, the Inspector General of Banks, as the title suggests, had been responsible for the regulation and supervision of Canada's chartered banks.

Prior to the creation of OSFI, the Superintendent of Insurance had responsibility not only for federally licensed insurance companies (both Canadian-incorporated companies and the branches of foreign insurers) but also for federally incorporated trust and loan companies, federally regulated pension plans, and provincial central cooperative credit associations which had opted in under the federal legislation. At first glance it seems strange to have grouped deposit-taking trust and loan companies under the insurance supervisor, rather than with the deposit-taking banks. However, at that time, trust and loan companies had extremely restrictive and detailed investment rules which were very similar to those applying to insurance companies (the "legal for life" rules),[27] and it therefore made sense for the governing legislation for all three types of institution (trust, loan and insurance companies) to be administered by the same regulator. In addition, all had limited business powers. These strict "legal for life" rules and restricted business powers had been in existence for decades and still applied at the time OSFI came into existence. They were not relaxed and updated until the 1992 reforms to the federal financial institution legislation came into effect – the first major overhaul in approximately 70 years.

Challenges of the Current Environment

Canadian financial institutions and those who regulate them face two major and interrelated challenges as they prepare to meet the 21st century. The first is the convergence of financial institutions and of the products they offer, as the lines of distinction between them become ever fainter. The second (which fuels the first) is the explosion of technology, which has made possible the delivery of financial services in ways that could not have been imagined 10, or even 5, years ago.

[26] R.S.C. 1985, c. 18 (3rd Supp.), as amended (the "OSFI Act").

[27] "Legal for life" refers to investments that had certain statutorily prescribed characteristics that made them suitable for investment by life insurance companies and by trust and loan companies.

Convergence

The relaxation of the rules governing federal financial institutions and the expansion of their powers, which began in 1987 and gained momentum in 1992, reflects similar trends throughout the world. So does the consolidation that has taken place and that is expected to continue both within and across pillars. Many Canadian financial institutions no longer identify themselves primarily as "banks" or "insurance companies," but refer to themselves as financial services groups – as in The Mutual Group and the TD Bank Financial Group. Increasingly, financial institutions offer a range of products and services that cut across traditional lines. This enables the consumer to carry out banking, insurance and securities activities, and wealth management with one institution or corporate group.

These expanded offerings are coming partly through cross-pillar ownership, with banks now owning insurance, trust and securities subsidiaries and insurance companies owning deposit-taking institutions. Some securities dealers and mutual funds have access to payments services through a trust company subsidiary. In addition, some products offered by different financial institutions have very similar characteristics. Insurance companies, although not permitted to take deposits, offer products similar to those offered by banks. Money market mutual funds also compete with savings accounts offered by deposit-taking institutions.

Technology

Technology has fuelled this convergence by making available new distribution channels and by enabling vast quantities of information to be manipulated at lightning speed. For example, the personal computer banking and Internet sites of Canadian banks offer consumers the ability to undertake banking transactions, to purchase securities and to arrange mortgages from the convenience of their homes. Only the legislated prohibition barring banks from selling insurance has prevented them from also offering insurance products.

In addition, technology has enabled financial institutions, both domestic and foreign, to do business without the expense of operating on a branch basis. Citizens Bank, a subsidiary of Vancouver City Savings Credit Union, operates across Canada through the Internet and telephone in a "virtual" world without brick-and-mortar branches. The same applies to the giant European insurance and banking conglomerate ING. Like Citizens Bank, ING Bank of Canada has no branches and operates through a call centre. Wells Fargo Bank, based in California, has started lending directly to Canadian small-business borrowers without any physical establishment or representative in Canada. It operates by mail and telephone, with sophisticated data manipulation and credit-scoring systems made possible by technology.

Technology has sped up changes in the financial services sector in Canada and elsewhere. The Bank Act, which used to be updated every decade, underwent further major changes 1997, only five years after the 1992 reforms, as did the other federal legislation. A further five-year review is scheduled to take place no later than 2002. Federal financial institution legislation has in fact been amended in one way or another almost every year since 1992. This trend is expected to continue. Notwithstanding these revisions, regulation of financial institutions and changes to the applicable legislation have not kept pace with unfolding events.

Issues

The challenges of convergence and technology are leading to a re-examination of regulatory structure in many countries. The United Kingdom this year has begun the consolidation of its supervisory regimes in the form of the Financial Services Authority (FSA). Following the Report of the Financial System Inquiry published in March 1997 (the "Wallis Report"), Australia is creating the Australian Prudential Regulatory Authority (APRA), responsible for the prudential regulation of all financial institutions. In establishing a unified regulatory body in the form of OSFI in 1987, the Government of Canada was ahead of its time.

The early establishment of OSFI has enabled the Canadian regulator to blend its operational methods over the years into a unified approach to regulation and supervision. Notwithstanding Canada's early establishment of a unified supervisor for its financial services sector, it is timely to review a number of issues where further action appears desirable.

The four main topics covered by this background paper and listed at the beginning of the chapter are summarized below. They are discussed in greater detail in chapters 2 to 5.

The Role of OSFI

Convergence and technology are resulting in increasingly complex corporate structures and the creation of multi-business, internationally active financial conglomerates. The presence of effective competition in domestic markets is becoming increasingly important as consolidation in the Canadian financial services sector continues. The ability of OSFI to effectively supervise and regulate in these circumstances may be enhanced by a clearer mandate and creation of a board of directors. It is time to reconsider both OSFI's governance and its mandate.

Other issues related to the regulatory role of OSFI involve the need to streamline some of the regulatory processes in which OSFI is involved. These include:

- continued reduction in intergovernmental overlap among provincial regulators and between OSFI and provincial regulators;
- elimination of overlapping and sometimes conflicting regulatory rules at the federal level between CDIC and OSFI; and
- simplification of many of OSFI's own processes, particularly those relating to the numerous approvals required under the federal legislation for various transactions carried out by financial institutions.

Product Insurance Plans

While the various elements of the financial services industry in Canada continue to converge, the plans that insure consumers who purchase financial products have not. Compensation for customers of a financial group offering both deposits and life insurance is fragmented into two basic plans:

- CDIC, a Crown corporation, insures deposits made with banks and other federal and provincial deposit-taking institutions.
- The Canadian Life and Health Insurance Compensation Corporation (CompCorp), a private, non-profit corporation established by the life insurance industry in 1990, insures life and health insurance policies and other products of life insurers, some of which are very similar to the products of deposit-taking institutions.

In addition, there are insurance funds available to protect against losses by customers of brokerage houses and of property and casualty insurance companies. Further, there are provincial credit union deposit insurance plans.

In a world of financial conglomerates and converging institutions and products, with the possibility of further consolidation in the deposit-taking sector, life insurance companies have the possibility of providing real competition to the banks. This competition should be encouraged, but the asymmetries between the CDIC product insurance plan for deposit-taking institutions and the CompCorp plan for life insurance companies may detract from the effectiveness of this competition. The most important of these asymmetries are the government guarantee of obligations enjoyed by CDIC, and its access to the CRF. Neither of these benefits is available to CompCorp.

Market Entry without a Physical Presence

Technological advances have made possible the provision of financial services to Canadian residents by foreign financial institutions, without the necessity of such firms having any physical presence in Canada. This phenomenon is still in its infancy but is expected to grow rapidly. While the competition should be welcomed, Canada has no special regulatory or supervisory framework to apply to it.

International Supervision

Ultimately, as globalization and convergence continue, the only way to regulate effectively may be through international cooperation and perhaps through international regulatory organizations. The European Union is an example of this kind of cooperation, recognizing the regulation and supervision of the home jurisdiction. There are a number of international organizations that act as quasi-regulators or coordinators with respect to financial institutions. These include the Bank for International Settlements, the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Organization of Securities Commissions, the International Monetary Fund (IMF) and the World Bank.

Canada's Minister of Finance has recently called upon major industrialized nations to establish improved surveillance mechanisms for national financial systems. Ways in which this might be done are under active consideration by the Group of Seven (G-7), the IMF and the World Bank.

Chapter 2

The Role of OSFI

The forces of change sweeping across the financial services industry have profound implications for regulators. Multi-business, multi-product, internationally active financial conglomerates have come to typify the financial services sector. There are increasingly complex corporate structures. Global risk management takes place inside institutions, based on a global approach to country of origin, legal entity and the specific product from which the risks have emanated. The businesses of banking, insurance, securities and trusts intermingle. Geographic restrictions on capital flows have virtually disappeared. Enabled by technology, financial institutions are engaged in the constant innovation of products, delivery vehicles and risk management techniques. All of the traditional financial services businesses have, in recent times, become far more difficult to understand and manage as their product lines, which were originally few and easily understood, have evolved into numerous, often complex products and services.

As noted in research done for the Task Force,[28] in submissions to the Task Force and in discussions with OSFI and other regulators, this rapidly changing environment is creating huge challenges for regulators around the world. In many countries, new regulatory structures are being put in place. In others a careful look is being taken at the institutions which have regulatory responsibilities and the way in which they are organized.

The regulatory structure must be looked at from the perspective of this much broader context. The challenge of modern prudential regulation is to find ways to supervise more innovative, entrepreneurial institutions effectively, without stifling the competition and dynamism that come from innovation. This requires an appropriate balance between safety and soundness, on the one hand, and competition and international competitiveness, on the other. Underlying this balance is the need to ensure both that OSFI's consumer protection role is made explicit and that the level of intervention in the business operations of financial institutions is the minimum necessary to carry out those objectives.[29]

[28] McKinsey & Company, "*The Changing Landscape for Canadian financial services: New forces, new competitors, new choices,*" Report to the Task Force on the Future of the Canadian Financial Services Sector, (Ottawa, September 1998); see in particular, Ch. 7.

[29] See Background Paper #1, *Competition, Competitiveness and the Public Interest,* Ch. 1; and Task Force on the Future of the Canadian Financial Services Sector, Discussion Paper, June 1997, p. ii.

This chapter suggests initiatives that the Task Force believes will help OSFI in this fluid and complex environment to be more effective in balancing safety and soundness with competition, while at the same time enhancing consumer protection. The issues discussed in the chapter include:

- the mandate and governance of OSFI; and
- the streamlining of regulatory overlap and approval processes.

Description of OSFI

The Present Structure of OSFI

The Superintendent

Under the present legislation, OSFI is an office of the Government of Canada. The Minister of Finance is responsible for the office and reports to Parliament to fulfil that accountability. OSFI is headed by the Superintendent, who is appointed by the Governor-in-Council for a seven-year term and is designated by the OSFI Act as the deputy head of the office. The OSFI Act provides the Superintendent with a substantial degree of independence in the day-to-day operation of OSFI. The Superintendent, who holds office during good behaviour, may be removed from office only for cause by the Governor-in-Council, in which case the Order-in-Council providing for the removal and related documents must be laid before Parliament. The Superintendent is required to report to the Minister on the administration of statutes falling within OSFI's jurisdiction and is personally responsible for providing a number of approvals and taking specified action under the statutes. In certain instances, ministerial approvals or actions are required when operating decisions have public policy implications.

Thus, the statute provides for effective supervision through the vesting of significant operating powers in an independent Superintendent. At the same, time there is accountability to Parliament through the Minister.

Unlike CDIC and the Bank of Canada, the OSFI Act does not provide for a board of directors to act in a consultative or oversight capacity in the governance of OSFI. The lines of authority run first to the Superintendent and then, in all matters, directly to the Minister of Finance.

Below the Superintendent lies a hierarchical structure with approximately 400 employees in four main sectors. The Superintendent is empowered to appoint one or more Deputy Superintendents and there are currently two, heading the Supervision Sector and the Regulation Sector respectively. An Assistant Superintendent heads the Corporate Services Sector, and a third Deputy Superintendent is being selected to head the fourth sector – Specialist Support.

Institutions and Legislation Supervised and Administered by OSFI

OSFI has responsibility for approximately 490 financial institutions. Exhibit 2.1 provides a breakdown among banks, trust, loan and insurance companies and fraternal benefit societies.[30] Exhibit 2.2 displays some aspects of regulatory supervision that are considered by OSFI in establishing the level of supervision thought necessary, based on an assessment of institutional risk, methods of monitoring risk and other specific considerations.

Exhibit 2.1
Institutions Regulated by OSFI

Type of Institution	Number of Institutions
Schedule I banks	8
Schedule II banks	50
Trust companies	34
Loan companies	25
Life insurers	129[1]
P&C insurers	220[2]
Fraternals	27[3]

Note: All figures as of March 18, 1998, unless otherwise specified.
[1] As of January 23, 1998
[2] As of January 22, 1998
[3] As of January 21, 1998
Source: OSFI Web site: http://www.osfi-bsif.gc.ca/AndreE/

In addition to duties imposed by the OSFI Act, OSFI is responsible for administering the following federal legislation and the regulations thereunder:

- the Bank Act;
- the Insurance Companies Act;
- the Trust and Loan Companies Act;
- the Cooperative Credit Associations Act; and
- the Pension Benefits Standards Act.

Duties are also imposed on OSFI by portions of the Income Tax Act and the Public Pension Reporting Act.

[30] OSFI also regulates one cooperative credit association (Credit Union Central of Canada) pursuant to the Cooperative Credit Associations Act and six provincial cooperative credit societies (centrals) that have opted in under that Act; it also has responsibilities in connection with federal pension benefit plans.

Exhibit 2.2

Aspects of Regulatory Supervision

The level of supervision established by OSFI is based on the risk assessment of an institution and/or its subsidiaries and applicable statutory obligations. In addition, the level of supervision will be a function of the types of activities that are undertaken by the institution or its subsidiaries. Exhibit 2.2 outlines the main variables that are involved when OSFI is determining the level of supervision that should be applied to an institution and its subsidiaries.

Risks Considered	Methods to Monitor Risk	Specific Considerations
• Credit risk from the potential of a borrower failing to meet obligations; risk to the institution and the payments system • Market risk: adverse movements in prices • Liquidity risk: ability to meet obligations under normal and adverse conditions • Operational risk: from inadequate information systems, breaches of internal controls, lack of policies, inadequate audit programs, fraud, lack of disaster planning, poor management, inactive board of directors • Legal risk: from potential lawsuits and liability • Risk to reputation: from the impact of negative information that would motivate clients to take business away	• Applying standards of governance for a board of directors • Regular reporting requirements on key information and analysis of the information by OSFI • Full-time on-site audits and inspections • Self-attestations concerning compliance with and reporting on established standards • Spot checking with on-site visits • Review of the Minutes of Management/Board meetings • Review of company audit reports • Establishing requirements for transactional approvals • Review reports of a lead regulator or of foreign regulators • Undertaking special system-wide studies	Whether there is direct or indirect jurisdiction over the company or one of its subsidiaries; (example: a domestic bank versus a foreign owned bank). The quality of management and financial policies, practices and controls; the quality and frequency of internal and external audits. The size of the potential risk that a subsidiary could pose to the parent DTI or insurance company in terms of: • the size of guarantees in force between the entities; • the amount and likelihood of other potential liabilities; and • the amount and ratio of assets at risk through a subsidiary. The degree of interconnectivity between a parent and a subsidiary involving such things as: • the sharing of core activities including human resources, finance, information systems, etc.; • the potential for self-dealing; • the common use of key staff and management personnel; • the adoption of similar corporate policies; and • the degree of fiscal control by the parent. For DTI's, the quality and level of self-compliance with OSFI guidelines and CDIC's Standards of Sound Business and Financial Practices; for life insurers, self-compliance with the standards set by OSFI and CompCorp. The level and control of capital, and the quality of capital management standards applied to the institution and subsidiaries. Whether the institution is widely held.

Source: Compiled by Task Force staff.

OSFI's Regulatory Powers

Many transactions carried out by the financial institutions under the supervision of OSFI require the approval of the Superintendent. In addition, OSFI has almost unlimited power to require information from the institutions that it regulates, and has the power to examine such institutions and gain access to their records. The Superintendent may issue directions of compliance to institutions and, where the circumstances warrant, take control of the assets of a financially troubled institution and suspend the powers of its directors and officers in an effort to rehabilitate the institution. If rehabilitation fails, the Superintendent may ask the Attorney General of Canada to apply to a court for a winding-up order.[31]

As a consequence of its responsibility for administering the relevant federal legislation, OSFI has in recent years assumed powers with respect to various aspects of consumer protection, including disclosure requirements, privacy issues and consumer complaints. When the recently enacted tied-selling section of the Bank Act is proclaimed, OSFI will have responsibilities in this area as well.

The Task Force has considered whether OSFI should continue to have responsibilities in the area of consumer protection, particularly in light of the substantial changes that it is recommending to the consumer protection framework.[32] It has concluded that OSFI should continue to play this role, but that its mandate should reflect these responsibilities and it should have adequate resources to carry them out.

Emphasis on Safety and Soundness

Prior to the 1987 creation of OSFI, the Inspector General of Banks was responsible for the regulation and supervision of Canada's chartered banks and their compliance with the Bank Act. Banks have always played an important role in the Canadian economy and, until 1934, were able to issue currency. The banking legislation, which was reviewed every 10 years as a result of the "sunset" clause,[33] was fairly modern and up-to-date. Banks enjoyed expanded business powers, a range of permitted subsidiaries and the ability to invest in any type of company, up to certain limits.

[31] See, for example, section 543.1 of the Bank Act.

[32] See Background Paper #3, *Empowering Consumers.*

[33] The sunset clause is currently contained in section 21 of the Bank Act.

The Superintendent of Insurance had responsibility for federal insurance companies,[34] credit union centrals, and federal trust and loan companies.[35] The life insurance sector and the trust sector had similarly restrictive and detailed investment rules and limited business powers, which had been in existence almost unchanged for decades and still applied at the time OSFI was established.

The narrow focus of the Superintendent of Insurance was on ensuring that the institutions for which he had responsibility complied with the complex "legal for life" rules and kept within the limits of their restricted powers. The Inspector General of Banks was required to satisfy himself on an annual basis that the provisions of the Bank Act with respect to the safety and soundness of each bank were being observed.

The focus of the Department of Finance, of which the Inspector General was an employee, encompassed the stability of the financial system as a whole. The combination of the two regulators into OSFI was the genesis of OSFI's present focus on the safety and soundness of the institutions under its supervision and the overall stability of the financial system.

Over the years, OSFI has undergone a number of internal restructurings, which have resulted in the emergence of an integrated, modern supervisory body. OSFI has developed as an effective regulator of complex financial groups, with members representing different sectors of the financial services industry, both domestically and internationally, although the sector is evolving so quickly that regulatory challenges remain.

In 1996, OSFI was given a specific, legislated mandate. The emphasis was on safety and soundness, although it was recognized that OSFI's actions should not constrain competition. The 1996 mandate reinforced OSFI's existing tendencies to lean in the direction of giving primary emphasis to safety and soundness.

[34] Both Canadian-incorporated insurance companies and the branches of foreign insurers.

[35] The Superintendent of Insurance also had responsibility for federally regulated pension plans.

Mandate

Current Mandate

Until 1996, OSFI did not have a legislated mandate. The Department of Finance, in a White Paper published in 1995, concluded that OSFI should have such a mandate.[36] The White Paper stated that, in the absence of a clear set of legislated objectives, there was no defined standard against which to hold OSFI accountable to Parliament and to the Canadian public, or to measure its performance.[37] As a result, the OSFI Act was amended and now sets out the objects of OSFI in four paragraphs.[38] These objects are to:

- supervise financial institutions to determine whether they are in sound financial condition and in compliance with the law;
- advise management if this is not the case and require remedial action to be taken;
- promote the adoption by management and boards of directors of risk control policies and procedures; and
- monitor events at the industry level that may negatively affect the financial condition of institutions.

In carrying out these four objects, OSFI is instructed to strive to protect the interests of depositors, creditors and policy holders while at the same time "having due regard" to the fact that financial institutions must be allowed to compete effectively.[39] The Act also recognizes that it is not OSFI's role to prevent failure at all costs; that management and the board of directors are ultimately responsible for financial institutions; and that the competitive environment in which they operate necessitates the management of risks and may lead to failure, notwithstanding regulation by OSFI.[40] The purpose of the OSFI Act itself, as opposed to the objects of OSFI, is stated as ensuring that financial institutions are regulated in order to contribute to public confidence in the Canadian financial system.[41]

[36] Department of Finance, White Paper, *Enhancing the Safety and Soundness of the Canadian Financial System* (Ottawa, February 1995).

[37] Ibid., p. 6.

[38] OSFI Act, paras 4(2)(a), (b), (c), (d).

[39] Ibid., s-s. 4(3).

[40] Ibid., s-s. 4(4).

[41] Ibid., section 3.1.

Exhibit 2.3
OSFI's Mandate
OSFI Act, section 4

4 (2) The objects of the Office are:

(a) to supervise financial institutions in order to determine whether they are in sound financial condition and are complying with their governing statute law and supervisory requirements under that law;

(b) to promptly advise the management and board of directors of a financial institution in the event the institution is not in sound financial condition or is not complying with its governing statute law or supervisory requirements under that law and, in such a case, to take, or require the management or board to take, the necessary corrective measures or series of measures to deal with the situation in an expeditious manner;

(c) to promote the adoption by management and boards of directors of financial institutions of policies and procedures designed to control and manage risk; and

(d) to monitor and evaluate system-wide or sectoral events or issues that may have a negative impact on the financial condition of financial institutions.

(3) In pursuing its objects, the Office shall strive to protect the rights and interests of depositors, policy holders and creditors of financial institutions having due regard to the need to allow financial institutions to compete effectively and take reasonable risks.

(4) Notwithstanding that the regulation and supervision of financial institutions by the Office and the Superintendent can reduce the risk that financial institutions will fail, regulation and supervision must be carried out having regard to the fact that boards of directors are responsible for the management of financial institutions, financial institutions carry on business in a competitive environment that necessitates the management of risk and financial institutions can experience financial difficulties that can lead to their failure.

In tandem with its new mandate, OSFI adopted a mission statement, which reads in part:

> We are the primary regulator of federal financial institutions and pension plans. *Our mission is to safeguard policyholders, depositors and pension plan members from undue loss.* We advance and administer a regulatory framework that contributes to public confidence in a competitive financial system [emphasis added].[42]

[42] Office of the Superintendent of Financial Institutions, *Annual Report 1995-96,* p. 3; see also OSFI, *Annual Report 1996-97,* inside front cover.

OSFI's attitude toward competition is probably best summed up by comments on the subject contained in the 1995-96 Annual Report:

> OSFI's competition objective *does not call for the active promotion of competition* but rather an awareness that excessive regulation and supervision can stifle competition. OSFI must find ways of accomplishing its other objectives in a way that does not unduly impair the level of competition among financial institutions in the Canadian marketplace and the competitiveness of services available to the Canadian public [emphasis added].[43]

OSFI views its competition objectives as consisting primarily of monitoring the regulatory burden imposed on financial institutions, reducing regulatory overlap and duplication where possible, and developing performance measures for competition of regulated institutions and OSFI's impact in that area.[44]

The Task Force believes that OSFI has interpreted its mandate correctly but that the mandate needs to be strengthened and improved.

Experience in Other Countries

Other countries are also wrestling with the need to strike the right balance in the new environment in which financial services sectors everywhere are finding themselves. Examples of the elements that the Task Force believes should be reflected in OSFI's mandate can be found in the approach taken by Australia and the United Kingdom.

The Australian Model

Australia has recently made some fundamental changes to its regulatory structure, following the report of the Wallis Commission in 1997.[45] Among these changes is the creation of the Australian Prudential Regulatory Authority (APRA), responsible for prudential supervision of all deposit-taking and insurance companies and most pensions. Recognizing the importance of competition, the mandate of APRA balances this objective with safety and soundness, contestability and competitive neutrality, without making any one objective paramount. The proposed legislated mandate reads in part as follows:

> In providing regulation and developing policy, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.[46]

[43] OSFI, 1995-96 *Annual Report,* p. 7.

[44] OSFI, 1996-97 *Annual Report,* p. 24.

[45] *The Financial System Inquiry Final Report,* Canberra, Australia, March 1998 (the Wallis Report).

[46] *Australian Prudential Regulatory Authority Bill 1998,* s-s. 8(2), draft, Canberra, Australia, March 1998.

In the APRA mandate, the three components to be balanced with financial safety and efficiency are ensuring that institutions are strengthened in their ability to compete (competition), ensuring ease of entry (contestability) and ensuring that the regulatory regime does not favour any one player or group of players (competitive neutrality).[47] Unlike OSFI's mandate, the mandate of APRA clearly puts these competitive considerations on an equal footing with safety and soundness.

The U.K. Model

The United Kingdom is in the process of combining nine regulatory organizations into the Financial Services Authority (FSA). It is planned that the mandate of the FSA will be enshrined in the legislation accomplishing this, which is still at the drafting stage. The consultation paper outlining the FSA describes among its aims that of protecting consumers of financial services.[48] This aim will include:

- enforcing high standards of integrity, soundness, fair dealing and competence;
- ensuring that consumers receive clear and adequate information about services, products and risks; and
- ensuring that consumers are not exposed to unreasonable risks, while acknowledging that they are responsible for their own decisions.

A description of the approach of the FSA to its regulatory responsibilities includes this statement under the heading "Efficiency and effectiveness":

> **Competition and innovation.** The FSA will operate in a way which recognizes the benefits of competition and innovation to consumers, to the U.K. financial sector and to the economy as a whole, and which supports competitive and innovative markets for financial products.[49]

A New Mandate for OSFI

The Task Force believes that the current mandate of OSFI is deficient in three respects.

First, as noted earlier, the current mandate does not reflect OSFI's role with regard to consumer protection. In view of the recommendations that the Task Force is making to strengthen this role, it becomes even more important to recognize it in a statutory mandate.

[47] These ideas are discussed in the Wallis Report.

[48] Financial Services Authority, *Financial Services Authority: An Outline,* Appendix 1 (London, October 1997), p. 31.

[49] Ibid., p. 32.

Second, the mandate does not adequately reflect the need to balance safety and soundness considerations with the desirability of facilitating effective competition in domestic financial markets by recognizing the importance of competition in carrying out the regulatory mandate. This is particularly so with respect to reviewing applications for entry and proposals by existing institutions to introduce new and innovative ways of serving customers.

Third, the Task Force is of the view that the OSFI Act's reference to protecting "creditors" in addition to depositors and policy holders is confusing and unnecessary.

The Task Force proposes that OSFI should be given a revised and expanded mandate. The present mandate should be regarded as a building-block toward this end. The new mandate should put competition squarely in the scale with safety and soundness and require OSFI to balance the two. It should recognize that competition refers not only to the ability of existing players to compete effectively both domestically and internationally, but also to the facilitation of new entry and product innovation. It should reflect the fact that competition benefits consumers and businesses by expanding their choice of financial products and services and their choice of providers. Particularly in the present environment of rapid and radical change, the mandate should recognize, as it does now, that regulation and supervision by OSFI will not necessarily prevent failures. The mandate should also recognize explicitly the responsibility of OSFI to administer consumer protection legislation applicable to the financial institutions within federal jurisdiction.[50] The reference to protecting creditors should be eliminated.

Governance: An OSFI Board of Directors

The financial services sector in Canada and throughout the world is going through a period of unparalleled change and unforeseen complexity. Regulators everywhere are placing increased emphasis on the governance of institutions. In this context it is appropriate to re-examine the governance of regulators as well.

Many regulatory agencies carrying out public responsibilities similar to those of OSFI, both within Canada and abroad, have a board of directors or some other similar governance mechanism to provide more effective accountability. Four of those boards of directors – those of the Financial Services Commission of Ontario (FSCO), the Ontario Securities Commission (OSC), the Australian Prudential Regulatory Authority (APRA), and the Financial Services Authority (FSA) of the United Kingdom – are described in Exhibit 2.4.

[50] See Background Paper #3, *Empowering Consumers.*

Exhibit 2.4

Characteristics of Boards of Other Regulatory Agencies and Commissions

	FSCO **Financial Services Commission of Ontario**	**OSC** **Ontario Securities Commission**	**APRA** **Australian Prudential Regulatory Authority**	**FSA** **Financial Services Authority (U.K.)**
Function of agency or commission	Authority for insurance, trust and loan companies, credit unions and caisse populaires (excluding deposit insurance fund), cooperatives, mortgage brokers, pensions and real estate agents	Administers the Ontario Securities Act; oversees the Toronto Stock Exchange and the Investment Dealers Association	Prudential supervisory authority over all deposit-taking and insurance companies and most pensions. Market conduct will be the responsibility of another agency.	The Securities and Investment Board (SIB), which was the government agency that regulated the securities industry, has become the FSA. It will ultimately acquire the powers of, and replace, eight other agencies. It will supervise banks, insurance companies, non-bank deposit-takers, investment dealers, investment managers, exchanges and clearing houses. It will be responsible for prudential and market conduct regulation, and related policy.
Responsibilities of the board	• Provides regulatory services that protect the public interest and enhance public confidence in the regulated sectors • Recommends assessments to the Lieutenant-Governor in Council and approves fees subject to approval by the Minister of Finance • Makes recommendations to the Minister with respect to matters affecting the regulated sectors • Provides the Minister with an annual statement of its proposed priorities for the year and an annual report	The board of directors is composed of the members of the Commission and oversees the management and financial and other affairs of the OSC The commission, in addition to administering the Act: • Has full by-law making authority; by-laws are subject to Ministerial approval • Has chief responsibility for setting policy and making rules	• Licensing powers • Approval of significant management decisions • Monitors whether agency is meeting its mandate • Sets staff compensation levels • Approves financial institution initiatives requiring statutory approvals • Monitors financial institution prudential management and performance, and how agency management is dealing with problems	• Overall responsibilities for the FSA's affairs • Approves material transactions • Approves significant management decisions • Monitors whether agency is meeting its mandate • Sets staff compensation levels • Approves major financial institution initiatives requiring statutory approvals

Exhibit 2.4 (continued)

	• Provides resources for the Financial Services Tribunal	• Adjudicates disputes and issues binding decisions • Employs staff and sets compensation lelvels • Submits annual report to the Minister	• Approves significant enforcement actions • Approves policies applicable to financial institutions • Annual report submitted to the Minister	• Monitors financial institution prudential management and performance, and how agency management is dealing with very material problems; the rest are delegated to staff • Approves very significant enforcement actions • Likely to be involved in material guidelines applicable to financial institution • Annual report submitted to the Treasury commenting on the FSA's performance against its objectives
How the board is appointed	Members are appointed by the Lieutenant-Governor in Council. There are two executive and three independent members. While there are no specific requirements, efforts are made to include representation from insurance, pensions and other areas. Knowledge of industry is also looked for.	The Lieutenant-Governor in Council appoints the members. The Chair is automatically a member. There is no requirement to have ex officio members from other government departments and agencies. Members are normally chosen for their knowledge of the industry.	Members are appointed by the Treasurer. The CEO of APRA and the Chair of the market conduct regulator are automatically members. Two members are from the central bank. The rest of the members are independent and normally chosen to represent states and industry (and sometimes legal and accounting professions), although nothing exists in statute.	Board members are appointed by the Chancellor of the Exchequer. The Board consists of an executive Chairman, 10 non-executive directors (including a lead non-executive, the Deputy Chairman) and 3 further executive directors. Board members are appointed in the public interest, not in order to represent any particular constituency or sector.
Number of board members	5	9-14	9	14
Are the roles of CEO and Chair separated?	Yes	No. Chair is automatically CEO	Yes. By statute CEO and Chair must be separate.	The roles are currently separate, but this is not required by statute.

Source: Compiled by Task Force staff

Along with the expanded mandate proposed for OSFI, the Task Force has concluded that the operations of OSFI would be significantly enhanced through the addition of a board of directors to its governance structure.

Responsibilities of the Board

In general, the board would be responsible for *(a)* providing oversight of the conduct by OSFI of its business and administrative affairs; *(b)* approving major OSFI policies and strategies; *(c)* monitoring the achievement by OSFI of progress against its strategic plans and statutory mandate; and *(d)* ensuring that there is strong senior management, particularly in the appointment of the Superintendent. Each of these items is dealt with briefly here.

Oversight

OSFI has important continuing administrative issues, including in particular the development of business plans and of operating controls and practices to achieve effective performance at reasonable cost. Human resource policy and the ability to obtain and retain skilled managers and personnel will be critical to OSFI's effectiveness. Given the complexity of the financial services environment and the changing nature of regulation (particularly the move toward assessing the processes by which institutions manage risk), these issues will assume greater importance. Oversight of the administrative and business functions of OSFI by a knowledgeable board would, in the view of the Task Force, greatly assist the Superintendent in discharging these functions.

Approving Policies and Strategies

As with other companies and public institutions in an environment of rapid change, it is essential that there be a forum for strategic planning and policy development. The board's approval role in the strategic planning process can be critical in developing and implementing new strategic initiatives. It is important that the ideas of OSFI's senior management be challenged in active debate by capable and knowledgeable people. Within the present governance framework of OSFI, there is no structure for such dialogue. A board of directors would provide it.

Monitoring Progress

As OSFI seeks to fulfil its statutory mandate (including the changes which the Task Force has proposed), there should be a framework within the institution which ensures that there is a disciplined review on an ongoing basis of the manner in which the mandate is being fulfilled. This will be particularly important in an environment in which OSFI, like other regulatory agencies around the world, must grapple with the need to balance traditional safety and soundness goals with issues of competition and competitive neutrality. A board of

directors would provide a forum for the discussion of these issues and for the regular monitoring of progress toward their fulfillment.

Ensuring Strong Senior Management

Finally, it would be appropriate for an OSFI board of directors to have a clearly defined role in advising the Minister of Finance in the appointment of the Superintendent. The board would have an informed view as to the job qualifications necessary for the Superintendent at any particular time. The interface between the government and the financial community is, in large measure, through OSFI as regulator and, in particular, through the Superintendent. Given OSFI's mandate, it is vital that the Superintendent be a person who has the confidence of both the financial community and the government. The selection of an effective Superintendent, capable of leadership in a complex environment, would be materially assisted by having an effective board.

A board of directors should also approve senior appointments. In this process, and through its ongoing work, it would develop important insights as to the strengths and weaknesses of in-house candidates for Deputy Superintendent and other senior management positions, as well as thorough understanding of the needed qualifications and skills should it become necessary to look outside OSFI for candidates. The board would also approve compensation policies.[51]

The OSFI Board

The Task Force is of the view that the OSFI board should be small and should consist of a mix of experienced business-people (some with experience in the financial sector and others with broader business experience), people familiar with consumer issues, and people from professional disciplines who are familiar with the issues confronting the sector and its regulation. The Superintendent should be a member of the board, as should the Chair of CDIC, the Governor of the Bank of Canada and the Deputy Minister of Finance. An independent director should be the Chair. The board should be appointed by the Minister of Finance with the approval of the Governor-in-Council, and should be subject to strict conflict of interest and confidentiality standards.

The appointment power of the Minister is of particular importance. The Task Force does not propose that the Minister's existing accountability to Parliament for OSFI be altered. That being the case, it is important that the Minister should have full confidence in those persons who make up its board. Appointments should be on a non-partisan basis.

[51] The problem of attracting and retaining qualified personnel is an area to which OSFI itself has drawn attention; see OSFI, *1996-97 Annual Report*, p. 20.

The governance model which the Task Force is proposing would preserve the present accountabilities of both the Superintendent and the Minister in respect of operating decisions. The board's role would relate to the broader matters of strategic process and oversight noted earlier. Board consideration of operating decisions would be on an after-the-fact basis involving the subjection of specific OSFI actions in individual cases to audit, analysis and board oversight to determine how the organization has performed against its mandate and business plan. The role of the board should be clearly articulated in the enabling legislation so that there will be no confusion as to responsibilities.

Streamlining Regulatory Processes

Duplicative and conflicting regulation, together with long and cumbersome approval processes, lead to higher compliance costs and can discourage new entrants.[52] In today's financial service marketplace, with increasing competition from non-regulated and monoline providers, the cost of regulation can become a serious competitive disadvantage. This can lead to attempts to reduce costs by cutbacks in services, loss of jobs and branch closings. It is important that these costs be no higher than necessary.

Duplicative and conflicting regulation plus unnecessarily complex rules exist with respect to market conduct regulation as well as prudential regulation. The focus of this section is on prudential regulation. Aspects of streamlining market conduct regulation are discussed in Background Paper #3, *Empowering Consumers*.

Intergovernmental Overlap

The Source of the Problem

As described in Chapter 1, duplicative regulation of financial institutions stems in large measure from the division of federal and provincial jurisdiction over financial institutions. Provincially and federally incorporated financial institutions are subject to the applicable regulatory regime in each province in which they do business. Federally incorporated trust, loan and insurance companies are also subject to federal regulation. Banks, regulated at the federal level and considered the least subject to duplicative regulation, have been drawn into the regulatory maze because of their ability to own trust and insurance companies and securities dealers, all of which are regulated at the provincial level.

[52] A 1994 study by The Conference Board of the regulatory costs of compliance for deposit-taking institutions and insurance companies with respect to their operations in Canada found that administrative expenses and internal compliance costs amounted to $330.7 million annually. The study also found that compliance costs have a large fixed component. As a percentage of operating expenses, compliance costs for deposit-taking institutions with assets in Canada of less than $500 million were four times higher than for those with assets in Canada of $10 billion or more. Brent Sutton, *The Cost of Regulatory Compliance in the Canadian Financial Sector* (Ottawa: The Conference Board of Canada, May 1994).

Recent and Ongoing Initiatives

While much remains to be done to harmonize regulation among the provinces and to harmonize provincial and federal rules, great strides have been made in the recent past.

Deposit-taking Institutions

Until recently, the most pervasive example of overlapping regulation was the Ontario "equals approach." This required any trust or loan company registered to do business in Ontario to comply with the Ontario Loan and Trust Corporations Act[53] regardless of its jurisdiction of incorporation. The equals approach also required any such company to comply with the Ontario legislation across Canada, not only in Ontario. Since the Ontario legislation had far more limited investment powers than the 1992 federal legislation and different self-dealing rules, one result was that federal trust and loan companies could not take advantage, anywhere in Canada, of the new powers bestowed on them by the federal Trust and Loan Companies Act (except in the event that they chose not to do business in Ontario).

Ontario has recently repealed the "equals" provisions of its Loan and Trust Corporations Act. Further amendments to the Ontario legislation have permitted Ontario trust companies to apply for continuance as federal companies. Only six small Ontario trust companies remain. Ontario has kept control of corporate structure (incorporation, amalgamation, winding-up) plus some of the fiduciary regime, such as the prohibition against the investment of assets under administration in shares of the trust company concerned or in any of its related parties. It will continue to register federal and extra-provincial trust and loan companies doing business in Ontario. However, Ontario and a number of other provinces are re-assessing their role in the regulation of deposit-taking institutions and, to one degree or another are streamlining their regulatory processes.

The following are some of the additional initiatives that are in place or under way in the deposit-taking sector:

- Ontario now leaves the question of solvency regulation of federal trust companies entirely to OSFI.
- The Ontario and federal governments are engaged in a discussion on a possible realignment of Ontario's responsibilities for regulating trust and loan companies in the province.
- Ontario's investment rules have been harmonized with the federal rules.

[53] R.S.O. 1990, c. L-25, as amended.

- Manitoba hires OSFI to do examinations and report back to the Manitoba regulator.
- Saskatchewan has new legislation (not yet implemented) that will make the regulation of trust companies more consistent with federal regulation.
- British Columbia has delegated regulation with respect to capital requirements and investments to the regulator of the home jurisdiction.[54]

Life Insurance Companies

Regulatory harmonization has been on the agenda of the Canadian Council of Insurance Regulators (CCIR) for some time. The CCIR is attended by high-level representatives of the various regulatory agencies, including OSFI, and meets twice a year. It looks at emerging trends and works toward harmonizing legislation through model codes and standardized reporting requirements.

Provinces reserve the power to ensure that companies carrying on business within their jurisdiction are financially solvent and able to meet their liabilities. However, in the case of federally regulated life insurance companies, most provinces accept the examination and inspection of the regulator of the jurisdiction of incorporation, namely OSFI, for the purposes of capital adequacy.[55] Since federally regulated life insurers account for approximately 90 percent of the business written in Canada, this effectively means that the bulk of prudential regulation of life insurance companies operating in Canada is carried on by OSFI.

Discussions are under way through the Atlantic Insurance Harmonization Project to establish common insurance legislation for the four Atlantic Provinces.

The Standards of Sound Business and Financial Practices, developed jointly by OSFI, the life and health insurance industry and Quebec's Inspector General of Financial Institutions, are a newly emerged product of harmonization. They parallel similar standards issued by CDIC for deposit-taking institutions.

Property and Casualty Insurance Companies

Property and casualty companies face problems of duplicative regulation similar to those affecting life insurance companies. The Insurance Bureau of Canada (IBC) has commissioned a report on regulatory harmonization, and is working with the CCIR to identify and prioritize additional issues.

OSFI, the IBC and the industry's compensation plan, the Property and Casualty Insurance Compensation Corporation (PACICC), are jointly developing standards

[54] Except for Prince Edward Island and Newfoundland.

[55] One exception is Quebec. Quebec's Inspector General of Financial Institutions oversees Quebec companies, accounting for approximately 9 percent of the business written in Canada. There are only nine life insurance companies currently doing business in Canada that are incorporated in provinces other than Quebec.

of sound business and financial practice for the property and casualty insurance industry, similar to those which have been applied by CDIC for deposit-taking institutions and which have been developed for life companies.

OSFI and IBC are conducting a joint study to identify best regulatory practices in key insurance markets around the world that could be used to improve the Canadian regulatory system.

Further Measures to Reduce Overlap

The federal government is limited in what it can achieve by taking active steps to further eliminate provincial regulatory overlap. Its tools are moral suasion, cooperation and encouragement toward harmonization.

Harmonization

The Task Force notes the recent progress made by the provinces toward the goal of harmonization, and urges further efforts in this regard. Provincial governments and regulators should be encouraged to harmonize the laws and regulations applying to trust, loan and insurance companies. Cooperation with one another and with OSFI should be the order of the day, particularly in those areas that are relatively non-controversial.

Common Capital Adequacy Tests and Recognition of Home Jurisdiction

Common capital adequacy tests at the federal and provincial level should be developed for trust and loan companies. At the same time, the provinces should be encouraged to accept the opinion of the "home" regulator in the jurisdiction of incorporation (including OSFI) in certain areas (bearing in mind that in some instances, where more than one institution is involved, there may be more than one home regulator). The Task Force is of the view that the following areas are susceptible to this approach:

- capital adequacy and other areas of prudential regulation, including certification by the home jurisdiction that a newly incorporated institution has met the capital adequacy tests and other incorporation requirements; and
- corporate reorganizations, including acquisitions of control, acquisition of assets and mergers.

Centralization and Standardization of Forms, Information and Data

A central, electronic data base should be established which could be accessed by both the federal and provincial regulators. OSFI should take the lead in establishing this data base, with the provinces invited and encouraged to opt in. For the data base to work effectively, reporting formats and required information should also be standardized. Trust, loan, life, and property and casualty insurance companies should be able to file the required information in one

acceptable format with the data base. It would then be accessible to each federal and provincial regulator having jurisdiction.

OSFI as Prudential Regulator

The Task Force is of the view that the provinces should be encouraged in every way possible to delegate solvency regulation of trust, loan and life insurance companies to OSFI, as is already the case in some instances. These moves would result, over time, in a simplification and rationalization of Canada's regulatory regime for financial institutions. Among the benefits which would result would be a reduction in regulatory costs and an ensured consistent standard of regulation.

Overlap with CDIC

CDIC, as deposit insurer, has no direct regulatory role in supervising compliance with the applicable federal financial institution legislation. Nevertheless, the CDIC Act states that CDIC should be "instrumental in the promotion of standards of sound business and financial practices for member institutions."[56] This overlaps with that part of OSFI's mandate which instructs OSFI to promote policies and procedures for the management and control of risk, and the adoption of such policies by the financial institutions that it regulates.[57]

In 1993, CDIC published eight Standards of Sound Business and Financial Practices with which all member institutions must comply. The subjects of these Standards range from liquidity management to foreign exchange risk management to capital management.[58] In many instances, the subjects covered by the Standards are also dealt with in regulations or in guidelines and bulletins published by OSFI.[59]

CDIC has developed the Standards Assessment and Reporting Program (SARP). Since 1995, on an annual basis, SARP has required banks and other members of CDIC to sign a representation letter to the effect that the institution is complying with the Standards. Boards of directors are required to pass a resolution to the same effect. SARP is intended to provide CDIC "with some assurance that the management and the board of directors understand their responsibilities and that the member institution is managing its risk."[60]

[56] CDIC Act, para 7(b).

[57] OSFI Act, para 4(2)(c).

[58] The complete list is as follows: Liquidity Management, Interest Rate Risk Management, Credit Risk Management, Real Estate Appraisals, Foreign Exchange Risk Management, Securities Portfolio Management, Capital Management, and Internal Controls.

[59] Examples are the OSFI Guidelines on Capital Adequacy and Prudential Limits and Restrictions, and OSFI Bulletins on Substantial Investments and Substantial Investments in Securities Firms.

[60] Canada Deposit Insurance Corporation, *Annual Report, 1995-1996,* p. 3.

Amendments to the CDIC Act in 1996 gave CDIC the power to make by-laws introducing risk-based premiums, and CDIC has published a draft by-law in that connection.[61] Member institutions would be classified into one of four categories on the basis of a range of measures of their sound financial management. In a number of instances, in order to attain the highest category with the lowest premiums, the requirements of the draft by-law exceed the requirements established by OSFI. The Canadian Bankers Association (CBA) has suggested that:[62]

- The proposal would impose an assets-to-capital test (leverage ratio) of 17:1 in order to obtain a top score for capital adequacy.[63] OSFI, on the other hand, permits a ratio of 20:1 (already considered restrictive by the CBA), and is currently considering some increase in this ratio.
- The data required by CDIC substantially exceed the information required by OSFI to assess an institution's financial health.
- The scoring system is overly complicated, will require significant effort and expense in data collection and reconciliation, and may in fact end up not rewarding institutions that understand risk and have demonstrated expertise in its management.

The Task Force is of the view that all regulatory and supervisory functions should be centralized in OSFI. Responsibility for compliance with the Standards and SARP should be transferred to OSFI. At the same time, steps should be taken to modify the Standards, SARP and the applicable OSFI guidelines and bulletins so that they harmonize. Risk-based premiums should be based on information and data collected by OSFI, although CDIC would continue to set the premiums for the different categories.

On an ongoing basis, CDIC should be formally consulted on all proposed changes to regulations, guidelines, bulletins and any other OSFI policies that may affect the fulfillment by CDIC of its mandate. CDIC should have the right to review and comment at all stages of the process.

The Task Force considered whether CDIC and OSFI should be amalgamated. This had been suggested in the Estey Report and by the House Finance Committee. The Government has chosen to maintain separate insurance and supervisory operations, and an important consideration in this decision was recognizing that OSFI and CDIC have different purposes. As well, they have

61 CDIC Act section 25.1; Canada Deposit Insurance Corporation, CDIC Premium By-law Consultation Paper, July 1997; CDIC Premium By-law, Description of Revised Premium System and Review of Comments Received, February 1998.

62 Letters from the Canadian Bankers Association to CDIC dated October 3, 1997, and January 14, 1998.

63 The original CDIC proposal was for a ratio of 16:1.

different interests with respect to failing institutions. OSFI's objective is to seek remediation in order to sustain the viability of the institution. CIDC's objective is to limit its exposure as an insurer, which may lead it to wish the institution to be liquidated sooner rather than later. The Task Force agrees that these different purposes and interests suggest that OSFI and CDIC should not be combined.

Approval Requirements under the Federal Legislation

Banks and federally incorporated trust, loan and insurance companies are required to obtain consent from the Superintendent or the Minister for numerous transactions. Approximately 40 to 50 different assessments and transaction approvals are required to be made by the Minister. These transactions include incorporations, acquisitions of a significant interest in a class of shares, corporate reorganizations, acquisitions of certain substantial investments and exercising certain powers in-house rather than through a subsidiary. The Superintendent has responsibility for a similar number of transactions and events, including the issuing of orders to commence and carry on business, exemptions from the requirement to carry on data processing outside Canada, redemptions of shares, and granting a security interest in property.

In addition, certain transactions proposed to be entered into by a foreign bank in connection with a Canadian financial services business require consent of the Governor-in-Council.[64] These are:

- the establishment of a new Canadian financial services business;
- the acquisition of a substantial investment in a Canadian financial services corporation; and
- the acquisition of all or substantially all of the assets of a Canadian financial services corporation.

An additional complication is that many transactions require more than one approval pursuant to the same legislation. For example, the proposed incorporation of a financial institution requires approval from the Minister to incorporate; the proposed owner also requires approval from the Minister to acquire a "significant interest" in a class of shares. Furthermore, if the proposed owner is a foreign bank, consent of the Governor-in-Council under the Bank Act is also required, as described earlier.

These requirements for approval are a source of regulatory burden at the federal level in a number of ways. The process of obtaining approval is often lengthy and slow. Compliance may result in additional costs to financial institutions through loss of profits from cancelled transactions which, after long delays,

[64] Bank Act, section 521.

cease to be viable from a commercial perspective. New entrants may be discouraged from applying in the first place, thereby reducing competition and consumer choice. Conversely, efficient and transparent regulatory processes are tools that can be used to encourage new entry and competition.

OSFI's Proposals for Streamlining the Approval Process

OSFI has put forward a number of proposals for streamlining the regulatory approval process under the federal legislation.[65] Two broad categories for reducing the burden of approvals have been identified. The first consists of reducing the number of situations requiring approval; the second consists of improving the efficiency of the existing approval process where its elimination is inappropriate.

Category 1: Reducing the number of situations requiring approval

OSFI has identified three options for reducing the number of situations requiring approval, each of which would be suitable in certain circumstances:

i) Replacing approvals with notices

Notices could replace requirements for Superintendent approval in some instances. The institution would notify OSFI in advance that a transaction was to take place, rather than applying for formal approval.

OSFI suggests that in these instances a number of controls would have to be put in place. Examples of these are: the development of criteria for whether a transaction falls under a notice system; guidelines implemented by the Conduct Review Committee; the right of the Superintendent to negate inappropriate agreements; a certificate from the financial institution attesting that the transaction conforms to the legislative and related supervisory requirements; and verification of the attestation and underlying transaction by OSFI as part of the examination process.

ii) Eliminating approvals through "transaction materiality"

Criteria would be developed defining "immaterial" in relation to both the transaction and the size of the institution. In the circumstances where the criteria applied, application to OSFI for formal approval would not be required. The possibility that a series of "immaterial" transactions might be significant in the aggregate would have to be dealt with. OSFI would need the flexibility to modify the criteria after assessing how the system was working and to suspend the exemption from obtaining approval in some situations. Institutions on OSFI's "watchlist" might be precluded from using this expedited procedure – an incentive to "good behaviour".

[65] OSFI, *Streamlining Regulatory Approvals,* submission to the Task Force, (Ottawa, July 7, 1998).

iii) Eliminating approvals using institution-based criteria

This option is very similar to option *ii)*. It would involve developing criteria for well-capitalized and well-managed institutions, probably based at least in part on OSFI's ratings under existing examination procedures. Those institutions meeting the criteria would be exempted from obtaining formal approval for certain transactions. As in *ii)*, the criteria would probably be linked to the materiality of the transaction. Since this approach, unlike *ii)*, is not predicated solely on size, it could introduce more flexibility for smaller but well-run institutions.

A variant of this option would be moving the approval process to a lower level (for example, below the Deputy Superintendent) for institutions meeting specified criteria. An amendment to the OSFI Act would be required to permit the Superintendent to delegate transaction approval authority to a level below that of the Deputy Superintendent.

Category 2: Improving the efficiency of the approval process

The four options identified by OSFI are as follows:

i) Shifting approvals from the Minister to the Superintendent

Broadly speaking, the Minister's approval is required for public interest or public policy issues, and the Superintendent's approval is required for prudential or solvency issues. Transactions relating to entry into the financial services sector (such as incorporation and continuance), transactions which can alter the form of an institution (such as demutalization), large transactions (either from a financial standpoint or relative to the industry), and transactions that may lead to a change in regulatory policy fall into the first category. However, it may be possible to shift those that are small and straightforward from a policy perspective to the Superintendent. This suggestion is in line with the Task Force's view, stated elsewhere, that new entry should be facilitated by streamlined processes.

ii) Blanket or consolidated approvals

In some instances, several different approvals are required for the same transaction. One example is the case of mergers or acquisitions involving large or complex entities, where there are complex financing arrangements or numerous subsidiaries requiring separate approvals for changes in ownership or control. Another example is the situation where approvals may be required under more than one Act.

The system could be streamlined by a blanket approval for the various components of a transaction, or by deeming one approval to include all the approvals necessary for the various components. Blanket approvals might also be appropriate where the institution meets certain capital adequacy and quality of management criteria. There would need to be flexibility to deviate from blanket approvals if the circumstances warranted it.

iii) Deemed approvals

In this scenario, the institution would provide advance notice to OSFI, and in some instances to the public, that it intends to undertake a certain transaction. If OSFI does not respond within a limited time period (e.g., 30 days), it would be deemed to have approved the transaction. However, OSFI is of the view that this option may not result in any significant reduction in regulatory burden since institutions might be reluctant to proceed given the possibility of encountering the disapproval of OSFI after the fact.

iv) Fast-track approvals or advanced rulings

For certain transactions the institution could be required to provide less information and the transaction could be subject to less rigorous analysis, thereby expediting its approval. OSFI could also publish its position on certain types of transactions, approval for which would be expedited providing there were no unusual features. This kind of system would also be linked to OSFI's assessment of the quality of the institution.

The Task Force has not analysed these recommendations in detail, but it applauds the initiative and the direction that OSFI has taken in this matter. The Task Force proposes that a committee be struck with representation from OSFI, the Department of Finance and industry to develop these proposals further with a view to early implementation. In its view, this task should be an early priority of the new OSFI board. Priority should be given to finding solutions that will relieve financial institutions in those situations which impose the greatest regulatory burden.

The OSFI recommendations did not refer to the fact that decisions with respect to the entry into Canada of foreign banks are still required to be taken by the Governor-in-Council. The Task Force is of the view that these decisions should rest with the Minister of Finance.

Chapter 3

Deposit Insurance and Policy Holder Compensation Plans

Background

Depending on the product in question, Canadian consumers are protected under a number of different insurance plans when they purchase financial products. These plans generally provide insurance for the consumer against the possibility of failure of the financial institution and its inability to meet its obligations.

CDIC insures deposits at banks and other federally incorporated deposit-taking institutions, and at some provincially chartered trust companies. Members of credit unions and caisses populaires are not insured by CDIC but are protected by deposit insurance or guarantee plans that vary from province to province.[66] The Quebec Deposit Insurance Corporation (QDIC) also insures Quebec chartered trust companies. Life insurance products are insured through CompCorp, of which all life insurance companies are members. Policies issued by the property and casualty insurance industry are insured through the Property and Casualty Insurance Compensation Corporation (PACICC). The Canadian Investors Protection Fund (CIPF) insures security holders against the insolvency of securities dealers. These arrangements evolved at different times in response to different needs. As a result, they "differ substantially from one another as to the extent of coverage they provide, the extent of their authority over insured institutions, and other aspects of their operations."[67]

There have been a number of reviews of CDIC in recent years. This fact was recognized by the Task Force Discussion Paper, which nevertheless asked the question: "Are there changes that should be made in the nature of compensation arrangements provided in Canada for the customers of financial institutions, and in the way these arrangements are administered?"[68] The question was asked

[66] In some instances, the deposit insurance plan has access to short-term liquidity loans from CDIC.

[67] Task Force on the Future of the Canadian Financial Services Sector, Discussion Paper, June 1997, p. 37.

[68] Ibid.

partly as a response to an early submission to the Task Force by the Canadian Life and Health Insurance Association (CLHIA), which noted "the life and health insurance industry has serious concerns that the current framework confers important competitive advantages on deposit-takers relative to life insurers."[69]

Following on the question asked by the Discussion Paper, and because there are a number of different plans with different coverage depending on the financial product in question, the Task Force commissioned a research report to review the existing compensation schemes. The researcher was asked to identify any public policy concerns to which the compensation schemes might give rise, and to indicate possible alternatives. The report concluded that all the compensation plans were adequately funded and were not experiencing any fundamental problems.[70] However, the report confirmed that CompCorp and the life insurance sector were at a disadvantage. The playing field was unlevel and tilted in favour of CDIC and the deposit-taking industry, as a result of the government guarantee which applies to the obligations of CDIC as a Crown corporation and its ability to borrow from the Consolidated Revenue Fund (CRF) should the need arise. CompCorp does not enjoy either of these advantages. The report also commented on public confusion over the various plans and the products covered.

This chapter reviews the competitive disadvantage in which the life insurance industry finds itself. It outlines the proposals of the Task Force for reducing that disadvantage through combining CDIC and CompCorp into one compensation plan, either by integrating CompCorp into CDIC or by establishing a new, independent organization without Crown corporation status. Either model will have the advantages of levelling the playing field, reducing consumer confusion and easing the path to equivalent coverage for equivalent products.

Rationales for Deposit Insurance

The traditional rationales for deposit insurance reflect some of the reasons given for prudential regulation of financial institutions: the safety and soundness of the financial system; the protection of unsophisticated depositors with small deposits; and, to a lesser degree, the encouragement of competition through new entry, whether of small, regionally based institutions or foreign firms. While the present mandate of CompCorp is clearly focussed on policy holders' protection, with no reference to the larger objective of maintaining the stability of the financial system, in the case of CDIC matters are not quite so simple.

In 1985, the Government struck a Working Committee on CDIC; its final report argued that the insurance of small, unsophisticated depositors against

[69] Canadian Life and Health Insurance Association, letter to the Task Force dated February 28, 1997.

[70] A. Warren Moysey, *Deposit Insurance and Other Compensation Schemes*, Report to the Task Force on the Future of the Canadian Financial Services Sector, (Ottawa, September 1998), p. 29.

loss should be the primary objective of CDIC.[71] It cautioned that CDIC should not become involved in considerations affecting the stability of the financial system beyond that primary objective.[72]

CDIC was once more the subject of scrutiny in 1994, this time by the Senate Banking Committee.[73] The Senate Committee, which among other things was examining proposals that CompCorp be put on a more equal footing with CDIC, with access to the CRF, took as its premise that the primary objective of CDIC is the stability of the payments system. This led the Committee to reject proposals that CompCorp be given similar status to CDIC as a Crown corporation with the ability to borrow from the CRF, on the basis that life insurance companies were not part of the payments system.[74]

The Task Force has come to the conclusion that the relative importance of the various rationales for deposit insurance shifts over time and that events have moved on. There have been significant and ongoing improvements to the oversight of the Canadian payments system, which was already one of the most efficient and safe systems in the world. The risk management characteristics of the payments system are being strengthened through the explicit regulatory role and responsibilities of the Bank of Canada and the introduction of the Large-Value Transfer System. The Task Force believes that the existence of deposit insurance is less important than it may have been in the past as a mechanism to avoid instability in the payments system. The Task Force is of the view that it is the Bank of Canada, as lender of last resort to direct clearers and as guarantor of settlement in the Large-Value Transfer System (when implemented), that will be the stabilizing force in the event of a breakdown in the payment and clearing process endangering the financial system.

The report prepared by Warren Moysey came to the conclusion that the primary rationale for deposit insurance today is the protection of small depositors.[75] The Task Force agrees with this view. Secondary rationales today are the levelling of the playing field for new entrants to deposit-taking, and contribution to the safety and soundness of the financial system.

[71] Final Report of the Working Committee on the Canada Deposit Insurance Corporation (CDIC), submitted to Hon. Barbara McDougall, Minister of State (Finance), April 24, 1985.

[72] Among other things, the report emphasized the importance of market discipline and recommended the introduction of co-insurance as an essential ingredient of both market discipline and a sound financial system. It also recommended risk-based premiums. Neither of these recommendations was acted upon.

[73] Report of the Standing Senate Committee on Banking, Trade and Commerce, *Regulation and Consumer Protection in the Federally-Regulated Financial Services Industry: Striking a Balance* (Ottawa, November 1994).

[74] As far as CDIC itself was concerned, the Senate Banking Committee recommended co-insurance, a reduction in "stacking" and some form of risk-based premiums. While co-insurance was not adopted, the possibility of stacking was reduced to some extent in 1996, and the power to implement risk-based premiums was introduced in 1997 and is in the process of being implemented.

[75] Moysey, *Deposit Insurance*, pp.11-18.

Framework for the Issues

As described in Background Paper #1, among the forces of change shaping the financial services sector are globalization and technology. The distinctions among financial institutions are becoming blurred. The result is that the financial sector is converging into a single marketplace, with a need for regulation that is competitively neutral.[76]

The Life Insurance Sector: Converging Products and Changing Business

Canadian financial institutions are no strangers to this tidal wave of change. The example with which this chapter is concerned is the convergence of the business lines of banks and other deposit-taking institutions with those of life insurers. A number of products sold by life insurance companies have come to resemble those offered by banks and other deposit-taking institutions. Deposit and savings accounts have traditionally been the medium for wealth accumulation used by Canadians. Notwithstanding that life insurance companies are prohibited from taking deposits, as shown in Exhibit 3.1, some of the products they now offer are very similar to products offered by deposit-taking institutions.

In addition, both banks and life insurance companies offer Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs). Life insurers have identical powers to those of banks and trust and loan companies to issue payment, credit or charge cards. While life insurance companies as yet cannot provide a chequing account, many life insurance policies have a cash value component, and the Task Force is proposing that life insurance companies be given access to the payments system.

Indeed, life insurance companies are no longer only in the business of life and health insurance. The federal Insurance Companies Act itself, in describing the main business powers of insurance companies, states that they are now in the business of "providing financial services," with no explicit mention of insurance. Wealth accumulation products now account for approximately half of total Canadian premium income.[77]

[76] See Background Paper # 1, Chapter 2.

[77] Canadian Life and Health Insurance Association (CLHIA), Submission to the Task Force, *Canada's Life and Health Insurance Industry: Consumer Compensation Arrangements,* October 1997, p. 17.

Exhibit 3.1
Example of Similar Products
Issued by Deposit-Taking Institutions and Life Insurance Companies

	Deposit-Taking Institutions	Life Insurance Companies
Product	**GIC**	**Deferred Annuity**
Description	Term investment with guaranteed principal and interest	Same as GIC
Contract term	1 to 5 years	To age 65, 69 or later
Interest guarantee	Daily, or for contract term	Daily, 1 to 5 years
Cashable	End of contract term; earlier with market value adjustment	End of interest guarantee w/o penalty; earlier with market value adjustment
Interest	Fixed, or tied to equity index (such as TSE 300)	Same as GIC
Insurance conversion features	None	Life annuity purchase option
RRSP-eligible	Registered or non-registered	Same as GIC

The Unlevel Playing Field

CDIC is a crown corporation, with its obligations guaranteed by the Government and with the additional ability to borrow from the CRF when necessary. There is an accurate perception among Canadians that CDIC, with the strength of the Government of Canada behind it, will meet all of its commitments.

In contrast, CompCorp is not a crown corporation and has no entitlement to borrow from the CRF. The quality of its compensation commitment to customers is therefore not as strong as that of CDIC.

In addition, there is a clear difference in the recognition and preference given by Canadians to the brand names of CDIC and CompCorp. The name of CDIC is well known. CDIC has been in business for over 30 years and has had a successful and visible track record of acting promptly to protect depositors in cases of financial institution insolvency. On the other hand, CompCorp is little known, having been in existence for only eight years and having had far fewer occasions to demonstrate its capabilities.

The Task Force has reviewed survey data relating to these issues.[78] It has also received evidence that customers may select products of deposit-takers rather than competing products of life insurance companies because of the strength of the CDIC compensation insurance:

> The case study evidence includes the decision by the trustees of a large ($100M+) university pension plan to transfer management of the plan's assets away from one of Canada's largest insurers. In their written explanations to plan members, the trustees point out that CompCorp "is only backed by the insurance industry, unlike the arrangement for Canadian banks that provides deposit insurance backed by the Government of Canada."[79]

Life insurers will continue to remain at a disadvantage to their deposit-taking competitors as long as the product insurance programs differ so fundamentally. This situation is of particular concern now that the products offered by financial conglomerates are becoming more and more alike.

The Task Force has concluded that there is public recognition that the quality of the compensation commitment given by CDIC is stronger than that of CompCorp, and that this market reality creates a competitive disadvantage for life insurance companies, compared with deposit-taking institutions. If financial conglomerates, led by life insurance companies, are to become robust competitors to the large banks, the competitive disadvantage inherent in the compensation arrangements should be removed.

CDIC and CompCorp

Structure and Powers

CDIC

The CDIC Act sets forth three objects of CDIC:

- to provide insurance against the loss of deposits;
- to be instrumental in promoting sound business standards and financial practices of financial institutions, and contributing to the stability of the financial system in Canada; and
- to pursue the first two objectives in such a way as to minimize the exposure of CDIC to loss.[80]

[78] Angus Reid Group, Inc, "Consumer Protection Plans" in *Confidence in Financial Institutions*, April 1997; "Consumer Evaluation of Regulatory Issues" in *Confidence in Canada's Financial* Institutions, 1992.

[79] CLHIA, *Consumer Compensation Arrangements*, p. 17.

[80] CDIC Act, section 7.

CDIC has a board of directors in which senior public servants participate. The Chair of the board is a person of "proven financial ability"[81] appointed by the Governor-in-Council. The board has five ex officio members, namely the Chair, the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Financial Institutions, and a Deputy Superintendent of Financial Institutions. Up to four other members are appointed by the Minister of Finance with the approval of the Governor-in-Council, none of whom may be a director, officer or employee of a federally or provincially regulated deposit-taking institution.

CDIC has the power to inspect its members and to order them to take specific actions.[82] It also has the power to attempt a restructuring of a deposit-taking institution in financial difficulty as a going concern. In exercising this power, CDIC is able to take control or acquire the assets of the institution concerned and to suspend any rehabilitation efforts undertaken by OSFI.[83] It has the power to make loans and guarantees to facilitate a restructuring.

There is consultation and information sharing between OSFI and CDIC. Not only do the Superintendent and the Chair of CDIC both sit on the board of CDIC, but they are also members of the Financial Institutions Supervisory Committee (FISC) set up under the OSFI Act and the Department of Finance Senior Advisory Committee (SAC). These structures provide an opportunity for the exchange of ideas with other government agencies involved with the financial institution sector.

CDIC is accountable to Parliament through the Minister of Finance. The Government has the power to issue a directive to CDIC overriding a decision of the board of directors, but no directive has ever been issued.

CompCorp

CompCorp is a private, non-profit corporation established by the life insurance industry in 1990.[84] The mission statement of CompCorp is to provide "Canadian policyholders with protection, within limits, against loss of policy benefits in the event of the insolvency of their insurance company."[85]

While CDIC's consumer protection commitments are legal obligations of the Crown, CompCorp's compensation obligations are not guaranteed by the government or by the participating insurance companies. In fact, CompCorp has no legal obligation to provide payment to policy holders at all; its arrangements are solely with OSFI and the provincial insurance regulators. While

81 Ibid., s-s. 6(1).

82 Such inspections are carried out on behalf of CDIC by OSFI.

83 Refer to Ch. 2 of this paper, under the heading "The Present Structure of OSFI."

84 Under Part III of the Canada Corporations Act, R.S.C. 1970, c. C.-32, as amended.

85 Canadian Life and Health Insurance Compensation Corporation, *Annual Report 1996,* p. 1.

CompCorp has the power to borrow from the private sector and from its members, it is not empowered to borrow from the CRF.

The board of CompCorp is made up of independent directors, none of whom may be a director, officer or employee of a member life insurance company. No public servants sit on the board of CompCorp. However, unlike the arrangements at CDIC, the Chairman of the industry association, the Canadian Life and Health Insurance Association, is a member of the board, and CompCorp has an industry advisory committee made up of senior executives of member companies elected by the members.[86]

In contrast to CDIC, CompCorp has no regulatory function[87] and no power to restructure a troubled life insurance company. It is not represented on any of the government committees such as FISC and SAC. While provision has recently been made for OSFI to share information with CompCorp,[88] any attempt to restructure a life insurance company takes place under the Winding-up and Restructuring Act[89] after a liquidator has been appointed. The provisions are more limited in scope than the powers granted to CDIC, in this instance under the CDIC Act.[90] CompCorp has limited ability to work with members to arrange the assumption of policies of an insolvent member, a member under the control of the regulator or a financially troubled member.

Membership

As of June, 1998, CDIC had 112 members, consisting of banks, other federal deposit-taking institutions and most provincial trust and loan companies. Credit unions, and in Quebec the caisses populaires and Quebec-incorporated trust and loan companies, belong to the deposit insurance system operated in their respective provinces. Membership in either a provincial scheme or CDIC is mandatory pursuant to various pieces of federal and provincial legislation, with one exception added to the Bank Act in 1997. The exception, which is not yet in force, will allow Schedule II banks, which do not take deposits of less than $150,000, to opt out of membership in CDIC. Provincial deposit insurers that have entered into an agreement with CDIC, the Credit

86 The industry advisory committee has seven members: three elected by large insurance companies, two by medium-sized companies and two by small-sized companies.

87 However, standards similar to the CDIC standards have been developed by OSFI in cooperation with provincial insurance regulators and CompCorp.

88 Insurance Companies Act, para. 672(2)(a.1), added by Bill C-82: The Superintendent may share information with "any compensation association designated by order of the Minister [i.e. CompCorp] ... for purposes related to its operations." At the same time, the parallel section in the OSFI Act, was amended by Bill C-82 by the addition of para. 22(2)(a.1), which reads, "any other agency or body that regulates or supervises financial institutions...." Strictly speaking, as pointed out above, CompCorp does not have a regulatory or supervisory role.

89 R.S.C. 1985, c. W-11, as amended.

90 CDIC Act, sections 39.1-39.38.

Union Central of Canada and those provincial centrals that have opted in under the federal legislation have access to short-term loans from CDIC for liquidity purposes.[91]

CompCorp currently has 195 members, consisting of all Canadian life and health insurance companies (including those which are Quebec-incorporated), those foreign life companies doing business in Canada on a branch basis and registered under the federal Insurance Companies Act, and the 67 property and casualty companies which offer accident and sickness insurance. Membership is mandatory pursuant to that Act and its various provincial counterparts.

Coverage

CDIC insures up to 100 percent of deposits made by consumers with member institutions, up to a maximum of $60,000 per account (inclusive of interest). To be covered by CDIC insurance, deposits must be made in Canadian currency and payable on demand or no later than five years from the date of the deposit. There are separate $60,000 limits for different kinds of account held by the same person. The result is that, in theory, one person holding each type of account at the same institution could be insured up to at least $360,000,[92] and quite possibly more. In addition, the same person can obtain the identical coverage for more than one of the same kind of account by holding them at two or more different institutions – a practice known as "stacking."

CompCorp insures life insurance policies up to a maximum of $200,000. However, it insures deferred annuities and other wealth accumulation products for the same maximum amount as CDIC, namely $60,000.

Details of the coverage provided by CDIC and CompCorp are compared in Exhibit 3.2.

[91] CDIC Act, section 39; the Cooperative Credit Associations Act, S.C. 1991, c.48, section 474 and Part XVII; only Quebec has entered into such an agreement for its deposit insurance plan.

[92] $60,000 each for a savings account, two joint accounts (one with a spouse and the other with a child), an RRSP, an RRIF and a deposit held in trust for a third party.

Exhibit 3.2
Comparison of Coverage Provided by CDIC and Compcorp

Product or Service	CDIC Coverage	CompCorp Coverage
Unregistered Products		
Deposits (including chequing, savings and GICs)[1]	$60,000	N/A
Post-liquidation interest on deposit accounts and GICs	Not covered	N/A
Deferred annuities	N/A	$60,000
Post-liquidation interest on deferred annuities	N/A	Contractual rate of interest on maximum of $60,000 to date of maturity
Non-registered policies (e.g., money accumulation products, cash value in life insurance policies)	N/A	$60,000 each
Registered Products		
Component of RRSP held in insured products	$60,000	$60,000
Component of RRIF held in insured products	$60,000	$60,000
Component of RRP held in insured products	N/A	$60,000
Other Products		
Retirement and disability income benefits	N/A	$2,000 per month
Health benefits	N/A	$60,000 to each covered person and each dependent
Death benefits from life insurance policy	N/A	$200,000

[1] CDIC has separate coverage for joint and trust accounts.

Funding

CDIC is funded by premiums levied against its member institutions on an ongoing basis. Despite this, in the mid-1980s, it became necessary for CDIC to borrow from the CRF in order to fulfil its obligations to repay depositors of failed member institutions. In its 1996-97 Annual Report, CDIC stated that as of March 31, 1997, its accumulated deficit was $1.2 billion, that its outstanding loans from the CRF totalled $865 million, and that it anticipated that the deficit and borrowing from the CRF would be virtually eliminated by March 1999[93]. In fact the deficit was eliminated and CDIC's loans were paid in full on July 22, 1998.[94]

[93] CDIC, *Annual Report, 1996-97*, p. 2.

[94] CDIC news release, July 22, 1998.

CDIC currently levies premiums on a semi-annual basis of one sixth of 1 percent of insured deposits, with a minimum of $5,000. The maximum that it is empowered to levy at the present time is one third of 1 percent of insured deposits.[95]

CDIC proposes to introduce risk-based premiums and has published a draft by-law in that connection.[96] Member institutions will be classified into one of four categories based on a range of measures of their sound financial management. Well-managed institutions will pay lower premiums. CDIC intends to bring in risk-based premiums as early as April 1999.[97]

CompCorp moved to pre-funding in 1996. It has the ability to levy an additional assessment on the liquidation of a member life insurance company in the event that the fund is insufficient. Funding is based on a percentage of five years' average premiums from insured classes of business. At the present time, the annual pre-funding assessment is 0.25 percent of premiums (amounting to a total of approximately $50 million per annum). In the event that on the liquidation of a member the fund is found to be insufficient, an additional annual assessment may be levied in the amount of 0.25 percent of premiums, and a temporary annual supplementary assessment of 0.35 percent of premiums may be levied for a maximum of seven years.

Priorities

Deposits have no priority over unsecured creditors (with the exception of deposits in trust companies, which are taken in the form of "guaranteed trust money" and as such rank ahead of unsecured creditors). Policy holders do have priority over unsecured creditors.

Amount Received on Liquidation

A deposit and a similar life insurance product of $60,000 or less will both be paid in full, regardless of the amount realized by the liquidation, as a result of CDIC insurance in the first case and of CompCorp coverage in the second. However, in the case of a deposit or insurance product that is *greater* than $60,000, differences in the way the proceeds obtained on a liquidation are applied can result in a difference to the total amount ultimately realized. The difference results from the fact that CDIC *insures* the first $60,000 of a deposit and any shortfall in the proceeds of the liquidation is applied pro rata to the insured and uninsured amounts of the total deposit, whereas CompCorp coverage ensures only that the policy holder is *paid at least* $60,000 at the end of the day.

95 CDIC Act, section 23.

96 CDIC, *Premium By-law Consultation Paper*.

97 CDIC news release, CDIC, *Annual Report*, 1997-98, p. 4.

The difference in the amount finally received by Depositor A with a $100,000 deposit and Holder B of a deferred annuity contract for $100,000, where the proceeds of liquidation are $0.90 on the dollar is shown in Exhibit 3.3.

Exhibit 3.3

Comparison of Loss Determination for Comparable Products of More than $60,000

CDIC			CompCorp		
Depositor A has a $100,000 deposit with a chartered bank.			Holder B has a $100,000 deferred annuity contract with a life insurance company.		
Depositor A is protected up to $60,000.			Holder B is protected up to $60,000.		
Assume that the proceeds of liquidation are $ .90 on the dollar.			Assume that the proceeds of liquidation are $.90 on the dollar.		
$100,000 x $ 0.90 (a shortfall of 10% or $10,000)	=	$90,000	$100,000 x $ 0.90 (a shortfall of 10% or $10,000)	=	$90,000
Insured amount	=	$60,000	Insured amount	=	$60,000
Amount paid by CDIC on failure of bank	=	$60,000	Since the proceeds of liquidation are more than $60,000, CompCorp is not required to add anything to the payment received by Holder B.		
The 10% loss is pro-rated to the insured and uninsured amounts, so that the proceeds of liquidation applied to the uninsured amount are as follows:					
Proceeds of liquidation received by Depositor A on the $40,000 uninsured amount (90% of 40,000)	=	$36,000	Holder B receives the total amount of the proceeds:	=	$90,000
Total received by Depositor A (60,000 + 36,000)	=	$96,000	Total received by Holder B:	=	$90,000
Depositor A's Loss	**=**	**$ 4,000**	**Holder B's Loss**	**=**	**$10,000**

A detailed comparison of the structure and powers of CDIC and CompCorp, and of other aspects of the two plans, is set out in Exhibit 3.4.

Exhibit 3.4

CDIC and CompCorp Compared

	CDIC	CompCorp
Crown corporation	Yes	No – federally incorporated non-profit corporation
Directors appointed by government	Yes	No
Provision for ex officio members of the board	Yes: • Chair of CDIC • Superintendent of OSFI • Deputy Minister of Finance • Governor of the Bank of Canada • a Deputy Superintendent of OSFI	No – but participating regulator entitled to attend board meetings
Directors independent of member institutions	Applies to all directors	Applies to all directors
Chair of industry association non-voting member of the board	No	Yes – Chair of CLHIA
Ex officio members of the board participate in other government committees	Yes – Chair and three senior ex officio members of the board (Superintendent, Deputy Minister and Governor of the Bank of Canada) are members of: • Financial Institutions Supervisory Committee (FISC) • Department of Finance Senior Advisory Committee (SAC) • OSFI/CDIC Liaison Committee	No
Industry Advisory Committee made up of senior executives of member institutions and elected by member institutions	No	Yes – 7 members, 3 elected by large-sized members, 2 by medium-sized members and 2 by small-sized members
Ability of member institutions to opt out of scheme	Yes – for institutions that do not take retail deposits (deposits of less than $150,000)	No
Legal obligation to provide payment	Yes – CDIC's consumer protection commitments are legal obligations of the Crown	No – contractual arrangements are with OSFI and each provincial regulator, in some instances backed by provincial legislation, not with policy holders or members. Courts have held in similar circumstances that coverage must be provided in a manner consistent with publicly disclosed guarantees of compensation.[1]
Mandatory compliance with standards of sound business and financial practice	Yes – promulgated through CDIC by-laws	No – although similar standards developed with regulators
Ability to order members to take specified action	Yes	No

Exhibit 3.4 (continued)

Ability to inspect members	Yes (undertaken by OSFI on CDIC's behalf)	No
Ability to force early intervention	Yes	No
Ability to take control and/or acquire assets of member institution	Yes	No
Ability to restructure an institution	Yes	Limited ability to make arrangements with one or more members to assume policies of an insolvent member, a member under control of the regulator or a troubled member
Ability to apply for a winding-up order	Yes	No
Ability to makes loans and guarantees to facilitate restructuring	Yes	No
Timing of funding	Premiums levied prior to failure; can be adjusted by government after failure occurs	Moved to pre-funding in 1996; additional assessments on a liquidation in the event the fund is inadequate
Funding	Semi-annual premiums: • Current: 1/6 of 1% of insured deposits • Minimum: $5,000 • Maximum: 1/3 of 1% of insured deposits	Annual administration fee of $6,000[2] Funding based on a percentage of five-year average premiums from insured classes of business ("premiums"): 1. Annual pre-funding 0.25% of premiums (approx. $50 million per annum) Additional assessments on a liquidation if fund insufficient: 2. Annual: 0.25% of premiums 3. Temporary annual, supplementary assessment (max. 7 years): 0.35% of premiums (approx. $70 million per year)
Access to the CRF for liquidity purposes	Yes – interest-bearing loans; Subject to aggregate borrowing limit of $6 billion	No
Ability to borrow from sources other than the CRF	Yes – subject to aggregate borrowing limit of $6 billion	Yes – including members
Ability to assess members for a proportion of losses on the failure of an institution	No	Yes – in addition, on a liquidation, right to borrow from members 3% of premiums from insured classes of business (approx. $600 million)
Risk-based premiums	Yes (not yet implemented)	No

Exhibit 3.4 (continued)

Average lag between failure and payout	3 to 5 weeks	Varies greatly depending on the type of policy
Accountability to Parliament through Minister of Finance	Yes	No – but Participation Agreement signed by the federal government and CompCorp allows regulators to block proposed changes in the by-laws or Memorandum of Operations if they object
Ability of government to give a directive overriding a decision of the board of directors	Yes	No
Ability to act as liquidator, receiver or inspector of member institutions	Yes	No – but may enter into agreements with liquidator and has standing in court proceedings
Priority of payment upon liquidation of a member institution	Depositors rank behind priority payment instruments (e.g., unpaid cheques) and certain employee claims, equally with unsecured creditors, and ahead of subordinated debt and liquidation costs	Policy holders rank behind costs of liquidation and certain employee claims, but ahead of unsecured creditors

[1] The case in question concerned the Canadian Investment Protection Fund, but the reasoning would almost certainly apply as well to CompCorp.

[2] Excess administrative costs are handled by a specific administrative assessment in proportion to the five-year covered premiums.

Source: A. Warren Moysey, "*Deposit Insurance and Other Compensation Schemes,*" Report to the Task Force on the future of the Canadian Financial Services Sector, September, 1998, Appendix 1.

New Approach

Basic Principles

As noted above, the Task Force has concluded that the primary rationale for deposit insurance today is the protection of the small depositor. Competition in the form of encouraging new entrants by not putting them at a disadvantage in relation to established players comes second. In searching for a solution to redress the competitive imbalance between deposit-takers and life insurers created by the two different product insurance plans, the Task Force agreed on three principles that should guide restructuring of such plans by the Government:

1) The minimum that is required to provide a more level playing field between banks and life insurers is to put CDIC and CompCorp on an identical basis with respect to the Crown guarantee. The Crown guarantee should apply to the obligations of both CDIC and CompCorp or to neither, and the ability to borrow from the CRF should be available to both or to neither.
2) Convergence at both the institutional level and the product level requires a parallel convergence of insurance plans. There should be one plan for both

deposit-taking institutions and life insurance companies, with a common administration and parallel coverage, but with separate funds and separate premiums to take account of the different risk profiles of deposit-takers and life insurers.

3) Product insurance plans should not have supervisory responsibilities.

The Task Force concluded that the continuation of two plans, even if with similar characteristics, is inefficient. Its conclusions are based on a number of factors: the increasing integration and overlap of financial services, existing examples of involvement of both insurance plans in the same failure, and the recommendation that life insurers become members of the payments system. The argument for one plan is bolstered by the fact that both deposit-taking institutions and life insurers are under the supervision of the same regulator, OSFI.

Levelling the playing field in a truly meaningful fashion requires structural changes to put CDIC and CompCorp on an even footing. In addition to levelling the playing field, the Task Force believes that one integrated plan would provide other benefits:

- A unified plan would assist in reducing current consumer confusion about coverage.
- A unified plan would provide an administrative framework within which to pursue comparability in coverage, priorities in the event of liquidation, and payout practices for products that are essentially identical although sold by different institutions.

Set out below is a blueprint for two different models, both of which would see CDIC and CompCorp amalgamated into a single body. In the first, CompCorp would be folded into CDIC as one Crown corporation, retaining the advantages of both the Crown guarantee of its obligations and the power to borrow from the CRF. In the second, CDIC and CompCorp would be amalgamated into one independent organization without benefit of a government guarantee but with the possibility of loans from the CRF.

Models for an Amalgamated Insurance Plan

Crown Corporation

The essential features of this model would be as follows:

- CompCorp would be folded into CDIC, which would remain a Crown corporation; as such, its obligations would be legally binding and backed by the government.
- Canada Deposit Insurance Corporation would be restyled as "Canada Deposit & Insurance Corporation" so that it could retain the name CDIC in

order to continue to take advantage of the "brand" and the degree of public recognition afforded it.

- The Crown corporation would have the same ability to borrow from the CRF as that now enjoyed by CDIC.
- The ex officio members of CDIC's board of directors would remain as members of the board and would continue to interact with the various governmental committees.
- The balance of the board would continue to be made up of independent directors.
- CDIC would be given the discretion to appoint and consult an advisory committee made up of industry representatives, if this were considered useful.
- The restructuring powers of CDIC would be extended to the life insurance industry.
- CDIC would maintain two separate funds, to which the two industries would contribute respectively. Premiums charged would be appropriate to the risks covered, and would not necessarily be identical for deposit-taking institutions and life insurance companies, at least initially. The amount of the premiums would be sufficient to build up a pre-fund for each industry.

Independent Organization

This model would reconstitute CDIC and CompCorp as an independent organization, but with considerable government and regulatory input. In this connection, it should be noted that a number of the Group of Ten (G-10) countries have deposit insurance plans which are independent of government, although in most instances there is significant participation by government, regulators and the central bank (see Exhibit 3.5 at the end of this chapter).

The essential features of the new independent insurance plan would be the following:

- CDIC would be amalgamated with CompCorp by legislation to form a new financial product insurance company, which would not be a crown corporation.
- The new insurer would be a non-profit organization, with no government guarantee of its obligations. The legislation would create a new backup lending facility to shore up the liquidity of the new insurer should this become necessary, giving the organization the ability (though not the right) to borrow from the CRF with the consent of the Minister of Finance. Any such loans to the new insurer would not only be at the discretion of the Minister, but would also be made on market terms and conditions and subject to other conditions prescribed by regulation or left to the discretion of the Minister.

- Public confidence in the new arrangements could be boosted by retaining the familiar name of CDIC (Canada Deposit & Insurance Corporation). However, the government would have to consider whether this would be misleading, since the new insurer would no longer benefit from a government guarantee of its obligations.
- The legislation would provide that the obligations of the new insurer to depositors and policy holders would be legally binding.
- The legislation would place constraints on the amount of premiums that could be charged.
- Changes to the by-laws of the new insurer would require approval of the Minister. The Minister would have the power to issue a directive to the board of directors.
- The composition of the board of directors would be limited to independent directors in the sense that none could be a director, officer or employee of a deposit-taking institution or life insurer.
- The board would be appointed by the Government. Provision would be made for the deposit-taking and life insurance industries each to submit a list of nominees from which the Government would appoint a minority of the directors. The Government would choose a majority of directors itself, and the Superintendent of Financial Institutions would sit as a director or alternatively be given the right to attend board meetings.
- The Chair would be appointed from among the directors chosen by the Government. The CEO chosen by the board would be subject to the approval of the Minister.
- The new insurer would be empowered, in its discretion, to appoint an industry advisory committee or committees along the lines of the CompCorp advisory committee.
- Depending on the scope of the legislation, the new insurer would enter into participation agreements with the federal and provincial governments similar to the participation agreements to which CompCorp is a party. These agreements would outline the obligations of the new insurer both to the governments and to depositors and policy holders. As stated earlier, the agreements would be made legally binding pursuant to the enabling legislation.
- The new insurer would be obliged to accept as members any federally chartered deposit-taking institutions or life insurance companies, and provincial institutions if their province of incorporation chose to opt into the new system.

- The new insurer would maintain two separate funds to which the two industries would contribute respectively. Premiums charged would be appropriate to the risks covered and would not necessarily be identical for deposit-takers and life insurers, at least initially. The amount of the premiums would be sufficient to build up a pre-fund for each industry.
- The issue of whether the new insurer would have restructuring powers should be considered by the Government in light of the appropriateness of this structure for such powers.

Conclusion

The Task Force is of the view that either model would solve the problem of the competitive imbalance created by the existing situation and would also serve to reduce consumer confusion. Both models are consistent with the three principles enumerated earlier in this chapter under the heading "New Approach."

The new, unified agency should be mandated to review all matters relating to products that are essentially the same although sold by different sectors where there are currently different or conflicting CDIC and CompCorp legal rules or policies. Among other things, comparability in coverage, priorities in the event of liquidation and payout practices should be considered and, where possible, reconciled.

Exhibit 3.5

Deposit Insurance Schemes of the G-10 Countries and the European Union

Country	Extent of coverage	Administration of system	Government guarantee or other backup	Base for premiums	Pre-funding
Belgium	ECU 15,000 until Dec. 1999; ECU 20,000 thereafter	Joint government/industry	Yes	0.2% covered deposits in ECU or any EU currency	No
Canada	$60,000	Government	Yes	1/6 of 1% of insured deposits	Yes
France	FF 400,000 per deposit	Industry	Significant government ownership and involvement in deposit-taking system	1. 0.1% of claims settled to max. of FF 200,000 2. Proportional contribution based on formula	No
Germany	100% up to a limit of 30% of the bank's liable capital per depositor	Industry (commercial banks – 25% of deposits)	Majority of deposits with credit unions and 100% of deposits in government-guaranteed savings and postal savings banks	0.03% of balance sheet item "liabilities to customers"	Yes + extra assessment if needed
Italy	100% of first 200 million lira and 75% of next 800 million lira per deposit	Industry (with input from central bank)	Significant government ownership and involvement in deposit-taking system	Maximum limit for fund: 4,000 billion lira; contributions according to formula	No; but banks commit ex ante
Japan	10 million yen per depositor	Joint government/industry	Large share of small retail deposits in postal savings banks with 100% government guarantee	0.012% of insured deposits	Yes
Netherlands	ECU 20,000 per depositor	Government	Bridge financing	Compensation apportioned among institutions; maximum of 5% of institution's own funds; maximum of 5% of all institutions' own funds	No
Sweden	SEK 250,000 per depositor	Government	Yes	0.25% of covered deposits	Yes

Exhibit 3.5 (continued)

Switzerland	SF 30,000 per depositor	Industry	No	1. Fixed fee based on gross profit 2. Variable fee based on share of protected deposits	No
United Kingdom	90% of protected deposits (maximum amount of protected deposits per depositor is £20,000, so maximum is £18,000)	Government	Yes	0.01% of deposits in European Economic Area currency less certain deposits by financial institutions and others	Yes; £10,000 at start-up; additional amount if fund below £3 million
United States	US$100,000 per depositor	Government	Yes	0% to 0.27% of domestic deposits; flat minimum of $2,000 for highest-rated banks	Yes
European Union	Aggregate deposits of each depositor up to a minimum of ECU 20,000	Must be at least one officially recognized deposit insurance scheme in each territory	Determined by each member	Determined by each member	Determined by each member

Source: James R. Barth, Daniel E. Nolle, Tara N. Rice, *Commercial Banking Structure, Regulation and Performance: An International Comparison*, Comptroller of the Currency, Economics Working Paper 97-6, Washington, D.C., March, 1997; research by Task Force staff.

Chapter 4

Market Entry without a Physical Presence

Changes Wrought by Technology

The explosion of technology has made it possible for foreign firms to provide financial services to consumers resident in Canada without the necessity of being physically present. However, there is no legislation, including the Bank Act, that contains a special framework that would apply to foreign firms desiring to provide financial services to Canadians without establishing a physical presence.[98]

Technology, and in particular technology's impact on processing information, has been one of the most important catalysts of change in financial services and the manner in which they are provided.[99] Together with the globalization of financial services, technological advances have enabled financial firms to provide services to consumers almost anywhere in the world without the necessity of establishing a physical presence.

While the rate at which technological changes are introduced and accepted is increasing in all areas of electronic commerce, the rate of change is especially rapid in the financial services sector, which is widely perceived as the "driver of electronic commerce."[100] Personal computers (PCs), the Internet, PC and telephone banking, electronic mail, interactive voice response technology, and call centres have changed the face of banking and the purchase of financial products and services in ways that were unimaginable even five years ago. A consumer sitting at home in Canada with a computer can open a new bank account, access an existing account and carry out numerous transactions

[98] Foreign firms attempting to take deposits or premium payments from Canadian residents fall under provincial securities law. See, for example, the Securities Act, Ontario, R.S.O. 1990, c. S-5, section 1, which includes both deposits and payments in the form of premiums for insurance in the definition of "securities," thus making them subject to securities rules. There may be enforcement difficulties where there is no physical presence. There are exceptions for regulated Canadian financial institutions.

[99] As described in Background Paper #1, Ch. 2.

[100] Report of the proceedings of the Turku, Finland, International Conference, "Dismantling the Barriers to Global Electronic Commerce," organized by the Organization for Economic Cooperation and Development (OECD) and the Government of Finland in cooperation with the European Commission, the Government of Japan and the OECD Business and Industry Advisory Committee (November 1997), p. 8.

including transferring funds and bill payments, applying for a loan or mortgage, purchasing insurance, and trading securities. There are already two examples of stand-alone Canadian-based "virtual" banks offering financial services to Canadians without a physical branch network. They are Citizens Bank of Canada, a subsidiary of Vancouver City Savings Credit Union, and ING Bank of Canada. Schedule I banks now also offer PC and Internet banking services to their customers, and the Business Development Bank of Canada has recently made loan applications available on-line.

The array of services that can be accessed is by no means limited to those provided from within Canada. While it has always been possible for Canadians to open a bank account or purchase insurance from an institution established in another country, the Canadian consumer today can access financial services offered from almost anywhere in the world without leaving his or her desk, without ever meeting a representative of the provider face to face and without the provider having any physical presence in Canada. These technological advances, coupled with the globalization of financial services, have led to what has been described as an "explosion of cross-border financial transactions."[101]

This exploding choice of financial services and methods of access does not come without problems. Transactions over the Internet and by mail give rise to uncertainties concerning the applicable law, the question of which country's courts have jurisdiction, the place where the contract is made, and electronic and digital signatures. The consumer may discover that he or she is subject to the courts and laws of the country of the provider.[102] Additional problems have arisen because regulators of financial institutions and financial services around the world have not been able to keep up with the changes. Regulation remains cemented in a legal regime designed in an era when cross-border financial services could be offered only through the establishment of a physical presence and through paper-based products. Canada is no exception, and the concern is that there is little, if any, protection for the Canadian consumer from pitfalls ranging from misrepresentation to outright fraud. Regulators around the world are searching for solutions to this new phenomenon.

The Issues

There are a number of competing objectives at play in designing a regulatory framework for foreign providers of financial services that are not physically present in Canada. One is to ensure that Canadians are able to choose from the

101 William R. White, *International Agreements in the Area of Banking and Finance: Accomplishments and Outstanding Issues*, Working Paper no. 38, Bank for International Settlements, Monetary and Economic Department, Basle, October 1996, Abstract.

102 Heather Rowe, "Electronic Commerce and Consumers," *International Business Lawyer*, vol. 26, no. 4 (April 1998), pp. 165-182.

widest possible selection of financial service providers and products. Another is to enable Canadians to become informed about the financial service providers they deal with, so that they can make valid assessments. A third is to avoid the imposition of a regulatory regime on these "virtual" providers which may be unworkable and discourage entry, at a time when additional competition would be valuable and should be encouraged, and when regulators in other countries are taking a wait-and-see attitude. The problem is that the scope of the issues is not yet fully apparent or understood, so it is difficult to formulate enforceable solutions. The challenge is to find a satisfactory balance among the objectives.

The Task Force is of the view that ultimately this kind of activity can be satisfactorily regulated only by the development of internationally acceptable rules which will be enforced by the home jurisdiction regulator. This chapter describes the gap in the existing Canadian legal framework as it applies to foreign financial service providers carrying out cross-border activities without establishing a physical presence in Canada, and makes some suggestions for interim solutions. These include a certification system for foreign lenders who engage in mass solicitation, and ways in which consumers can be kept informed about foreign providers.

The Existing Regulatory Regime

Foreign Banks

The Rules

The gateway for foreign banks intending to provide their services in Canada is the federal Bank Act. It contains extremely wide and far-reaching definitions of "foreign bank" and "entity associated with a foreign bank."[103] As a result, many foreign providers of financial services fall within these definitions even though one would not normally think of them as banks.

The Bank Act starts from the premise that all foreign banks are prohibited, directly or indirectly, from undertaking any "banking business" in Canada.[104] Because of the wide business powers now enjoyed by Canadian banks, "banking business" although undefined, is equated with offering almost any financial service, with the exception of underwriting insurance and selling securities.

Although there are several exceptions to the prohibition, they are all premised on having a physical presence in Canada. For example, if a foreign bank is actually a "bank," is widely held, is subject to acceptable regulation in its home jurisdiction and has at least $5 billion in assets, it may incorporate a Schedule II bank

[103] Bank Act, sections 2 and 507.

[104] Bank Act, section 508.

subsidiary to carry on a banking business in Canada.[105] Further, those foreign banks not meeting the criteria that wish to carry on a financial service business in Canada, whether through some other regulated financial institution such as a trust company or through an unregulated business corporation, are required to obtain an order of the Governor-in-Council pursuant to section 521 of the Bank Act. Section 521 is drafted in such a way that its application is implicitly limited to financial service providers establishing a physical presence in Canada. The avenue of section 521 is therefore not open to a non-resident provider of financial services that falls into the definition of a "foreign bank" and wishes to provide financial services to Canadian residents without establishing a physical presence. As a result, a provider in that situation either faces the outright prohibition against undertaking any "banking business" in Canada, or is not subject to the Bank Act at all, depending on the circumstances.

Exception for Syndicate Lending

Notwithstanding the provisions of the Bank Act described above, cross-border corporate lending into Canada is a common occurrence. Foreign banks, alone or as part of a syndicate, frequently provide loans to Canadian corporate borrowers. A convention (unwritten in the law, regulations or guidelines) has grown up, recognized by OSFI, that where a Canadian borrower is obtaining funds from a foreign bank or a syndicate of which a foreign bank is a member, the foreign bank will not be considered as undertaking "banking business" in Canada providing certain criteria are met. One criterion has been that the foreign lender is dealing one-to-one with the Canadian borrower and is not soliciting business from the public at large. Other criteria involve artifices such as the loan agreement being governed by a law other than the laws of Canada, the negotiation and signing of the contract at a place outside Canada and, so on.[106]

Wells Fargo Bank

In 1996 Wells Fargo, a well-capitalized U.S. bank, investigated the possibilities of extending its small-business lending activities to Canada. Based in California and using sophisticated scoring technology, Wells Fargo had no need of a physical presence in Canada any more than it did in the many U.S. states outside California where it was undertaking similar activities. Because Wells Fargo required no physical presence, the section 521 alternative was not available to

[105] It should be noted that these criteria are contained not in the Bank Act but in a publication of the Office of the Superintendent of Financial Institutions entitled *A Guide for Foreign Banks*. The option of incorporating a Schedule II bank is also available to widely held foreign insurance companies. To date, foreign banks have not been permitted to operate on a branch basis in Canada. The Government has indicated its intention to allow foreign bank branching.

[106] Taking security and realizing on assets in Canada have not been considered as abrogating the convention that the transaction takes place outside Canada, and therefore are not considered as contravening the prohibition against undertaking any "banking business" in Canada.

it. Since part of the business plan involved mass mailings to potential Canadian borrowers, OSFI initially took the view that Wells Fargo's proposed activities would be in contravention of the Bank Act prohibition against undertaking banking business in Canada. However, for technical legal reasons, OSFI accepted that the proposed general solicitation in the form of a mass mailing did not amount to undertaking any business in Canada and therefore could not be said to amount to banking business.

As a result, Wells Fargo could have carried out its small-business lending activities without consulting OSFI at all. However, it chose to enter into a dialogue with the Canadian regulator, voluntarily submitting to certain conditions (such as stating in its mailing material that it was not subject to Canadian regulation) and restructuring aspects of its business plan to further satisfy OSFI that it was not in contravention of the Bank Act prohibition. These re-engineered components included:

- mailing letters and statements from the United States, rather than having a direct-mail service enter into arrangements with Canada Post to "drop" the mail directly into Canada;
- locating its call centre outside Canada;[107] and
- arranging for interest payment cheques drawn on Wells Fargo's Canadian correspondent bank to be mailed by the borrowers to a post-office box outside Canada, only to be trucked back over the border for clearing with the correspondent bank.

These requirements make no sense from a business or prudential point of view.

ING Bank of Canada

ING is another example of a foreign financial institution which is successful in providing financial services through electronic means to customers in its home jurisdiction. ING carries out its activities in Canada through a Schedule II bank, ING Bank of Canada.[108] From a practical and business point of view, this physical presence may not have been strictly necessary, since its operations are conducted electronically and by telephone. As it is, ING has a minimal physical presence in its Canadian banking operations.

Since ING takes outward-bound deposits from Canadians, there would have been more reason for concern if ING had chosen not to operate through a federally regulated financial institution. In addition, ING was able to take advantage of becoming a member of CDIC, something it would not have been able to do without incorporating a deposit-taking institution in Canada.

107 Thereby depriving an estimated 150 Canadians of jobs. See Wells Fargo's Submission to the Task Force on the Future of the Canadian Financial Services Sector, p. 10.

108 ING Bank of Canada started as a trust company and was subsequently continued as a bank.

Foreign Insurance Companies

Foreign insurance companies deciding to do business in Canada can either incorporate an insurance company subsidiary or enter on a branch basis. Under the Insurance Companies Act, a foreign company "shall not in Canada insure a risk unless the Superintendent has, by order, approved the insurance in Canada of risks by the body corporate."[109] As is the case with the Bank Act rules applying to foreign banks, these provisions were crafted at a time when selling insurance without having a physical presence in Canada could only have been carried out on a very small scale, most likely with the potential Canadian customer taking the first steps to contact the foreign insurer.

To date there is little, if any, evidence of life insurers with no physical presence attempting to sell policies in Canada on any large scale. In the case of foreign property and casualty companies, some provinces allow the purchase of a policy from a non-registered insurance company if the kind of coverage required is not available from a registered company.

Inadequacies of the Existing Rules and Their Application

The provisions of both the Bank Act and the Insurance Companies Act were designed at a time when banking, insurance and other financial services could be offered in Canada only by a person or entity having a physical presence here. The reforms that came into effect in 1992 did not touch on the subject of electronic entry without a physical presence, nor did the overhaul of the legislation that took place in 1997.

A foreign financial firm that avoids being categorized as a foreign bank or foreign insurance company, is not subject to any federal financial institution legislation at all.

Foreign financial service providers that fall within the wide definition of "foreign bank" and that propose to offer financial services in Canada have five choices:

1) They can incorporate a regulated financial institution, with the attendant expenses at the federal level of the requirement to put up a minimum of $10 million in capital, a board of directors at least half of whom are Canadian, and ongoing compliance.
2) When the legislation is amended, they can enter Canada by way of a bank branch, which will require a physical presence.
3) They can make an application under section 521 of the Bank Act for consent of the Governor-in-Council, a procedure that is only available at the present time if the foreign bank intends to have a physical presence in Canada.

[109] Insurance Companies Act, s-s. 573(1).

4) They can obtain acceptance by OSFI that the proposed activities do not constitute an undertaking of "banking business" in Canada, which currently entails the problems encountered in the Wells Fargo example.
5) They can provide the financial service to Canadian residents from abroad without reference to OSFI and in a legal vacuum.

There is justification for requiring the incorporation of a Schedule II bank or a federal trust or loan company if the institution intends to take retail deposits. Indeed, it may even be a path which the foreign bank would choose in order to obtain membership in CDIC.

In the case of lenders, the option of OSFI providing a "comfort letter" to the effect that the foreign bank is not undertaking "banking business" in Canada is neither practical nor desirable. First, it necessitates the kind of artificial and impractical contortions of the business plan described earlier with respect to the Wells Fargo situation. Second, it lacks credibility. To the consumer, the argument that a company in the position of Wells Fargo is not engaged in "banking business" in Canada must appear absurd.

Proposals for Change

Starting Principles

The Task Force has based its conclusions on the principles set out below.

Consumer Protection

To the extent practicable, the Government should ensure that foreign financial companies dealing with Canadians respect Canadian market conduct regulation.

The Task Force believes that it is important for Canadians to have access not only to a wide choice of financial products and services but also to a wide choice of providers of those products and services, including foreign firms. The choice of provider should, to the greatest extent possible, rest with the consumer rather than the regulator. Canadian consumers should, however, be in a position to make informed decisions about financial service providers. Accordingly, any regulatory framework for "virtual" providers of financial services should not discourage foreign firms from offering their services in Canada by being complicated and expensive; at the same time, easily accessible information about such foreign firms should be available to Canadians.

Distinction between Lenders and Recipients of Funds

Extracting money from residents of Canada by means of deposits or premiums on insurance policies has the potential for far more serious problems than putting money into the hands of Canadians in the form of loans. The Task

Force is of the view that in the context of financial services provided by foreign firms without a physical presence, a different approach is required for lenders than that for takers of deposits and premiums.

Eventual International Regulation

In considering any regulatory framework for foreign financial firms that do not establish a physical presence in Canada but that provide services to Canadians, the Task Force believes that Canada should not get out of step with other countries, most of which are adopting a wait-and-see attitude. Care must be taken not to pre-empt regulation at the international level (which the Task Force considers will be the eventual solution) by imposing rules at the domestic level which will not be workable in that context.[110]

Exclusive Federal Jurisdiction with OSFI as Regulator

The Task Force is of the view that any regulatory regime applying to "virtual" financial service providers operating from outside Canada should be kept as simple as possible. Simplicity will encourage compliance and new entry, will enable consumers to understand the rules more easily and will not impede any decisions that may be taken at the international level. To this end, the Task Force considers that it would be preferable to have one regulator, OSFI, applying one set of rules contained in the Bank Act. OSFI, through its involvement with international regulatory bodies over the years, is also best positioned to represent Canada's interests at the international level.

The Banking Power

One of the hurdles to charging OSFI with regulatory oversight for foreign firms providing financial services to Canadian residents without establishing a physical presence in Canada is that in the context of financial services, the federal government has exclusive jurisdiction only over "banks and banking."[111] Wide though the Bank Act definition of "foreign bank" may be, it does not include all foreign providers of financial services. "Banking" is not defined in the Bank Act.

The Task Force is of the view that, for the limited purposes of foreign entry without a physical presence, undertaking "banking business" in Canada, as used in section 508 of the Bank Act, should be given a definition. This limited definition would specifically include as "banking business" financial services made available in Canada by foreign firms with no physical presence in any situation involving mass solicitation or target marketing of potential purchasers

[110] In this connection, the Department of Finance has noted: "In a fast-moving technological environment, it is often not possible for one country acting alone to establish effective and durable boundaries for prohibited activities." Department of Finance, *Foreign Bank Entry Policy*, Consultation Paper 2 (Ottawa, September 1997), p. 4.

[111] Section 91(15) of the Constitution Act, 1867.

of such services. For this limited purpose, the definition could include a reference to insurance activities and the collection of premiums.[112]

Such a definition would incorporate OSFI's original distinction between a general solicitation of business and dealings initiated by individual consumers.[113] This would also underline that no attempt is being made to interfere with the arrangements that individual Canadians may make with foreign financial service providers, whether here in Canada, over the Internet or by telephone, or in person in the country of the provider.

Proposed Framework

Lenders

A foreign lender wishing to make financial services generally available to borrowers in Canada without establishing a physical presence should be able to obtain certification to do so from OSFI, upon giving OSFI a binding undertaking that the foreign lender will:

- comply with market conduct rules applicable to banks in Canada;
- disclose that it is not regulated in Canada; and
- provide a mechanism for dispute resolution in Canada.

There is no suggestion that any attempt be made to impose prudential regulation on foreign lenders.

A modification to the Bank Act prohibition against foreign banks undertaking banking business in Canada would be required in conjunction with provision for certification of foreign lenders. "Banking business" undertaken in Canada would continue to be prohibited (with the existing exceptions), but would be stated to include the provision of any proscribed financial product or service by any non-resident that:

- does not establish a physical presence in Canada;
- solicits potential customers through mass solicitations or target marketing; and
- does not obtain certification from OSFI.

112 It should be noted that the Insurance Companies Act states that the business in which insurance companies are engaged is "such business generally as appertains to the business of providing financial services" – not the business of underwriting insurance. See subsection 440(1) of the Insurance Companies Act.

113 The Department of Finance has suggested something along these lines; see *Foreign Bank Entry Policy*.

A new exception would be made for foreign lenders that, upon providing a suitable undertaking, obtain certification from OSFI. Certification should allow them to develop a business plan that would not deny Canada appropriate economic benefits from ancillary activities such as call centres.

Those lenders who had received certification from OSFI and were not in breach of their undertaking could be entitled to exhibit a logo in their advertising and on their Web site indicating that they were certified by OSFI to carry on lending activities in Canada. This is a form of the "branding" or "accreditation" which has been suggested by the OECD, and which is referred to later in this chapter. The accreditation is similar in concept to that developed in the United States in respect of privacy on the Internet.[114] OSFI should maintain a list of institutions that it certifies.

In addition, information could be made available concerning the use of the logo or "seal of approval" on the Internet sites of lenders granted certification.

Takers of Deposits or Premiums

Extracting money from residents of Canada has the potential for creating far more serious problems than making loans to them. As already stated, Canada, along with many other countries, is adopting a wait-and-see position rather than rushing to legislate unenforceable rules, but this is not to say that Canada should remain passive. At the international level, Canada should be active in encouraging a common approach to this problem, based on regulation by the home jurisdiction. In the meantime, while recognizing that there may be problems with enforcement, the requirement that these activities be undertaken through a regulated Canadian institution subsidiary or Canadian branch of the foreign financial service provider should remain.[115]

Keeping Consumers Informed

OSFI lists at its Internet site every federally incorporated or federally registered financial institution that it supervises. It also maintains a "Warning Circular" listing over 200 entities which have come to its attention and that

[114] A U.S. independent, non-profit organization named TRUSTe licenses its "trustmark" ("TRUSTe") to participants subscribing to baseline privacy/disclosure principles. Among these principles are privacy statements available at each participant's Web site concerning the type of information gathered at the Web site, how the information is used and who it is shared with, and the ability of the consumer to opt out of information sharing and to update or correct information. The participants' Web sites are randomly audited for compliance by TRUSTe's official auditors, Coopers & Lybrand and KPMG Peat Marwick. There seems to be no reason why an idea such as this should not be expanded to the use by foreign lenders without a physical presence in Canada of a symbol on their Web sites to indicate OSFI certification.

[115] Under existing Canadian securities law, deposits and indebtedness under an insurance contract, other than those issued by banks and Canadian-regulated trust, loan and insurance companies, are classified as securities and subject to provincial securities legislation. See the definition of "security" in section 1 of the Ontario Securities Act, R.S.O. 1990 c. S-5.

may be operating in Canada illegally. The list is preceded by the following statement:

> Published periodically, the Warning Circular lists the names of entities which have been brought to the attention of OSFI through some form of inquiry or complaint. If these entities, or persons purporting to represent these entities, are operating in Canada, they may be violating provisions of the Bank Act. The following entities are NOT licensed chartered banks in Canada and are NOT registered representative offices of foreign banks in Canada.[116]

The lists of federally regulated financial institutions maintained at OSFI's Internet site are a step in the right direction toward keeping consumers informed. However, the Task Force is of the view that the lists should be expanded to include all regulated financial institutions, both federal and provincial, thus providing the consumer with one stop where all the information can be found. OSFI should collaborate with provincial supervisors in keeping the information up to date. In addition a list of lenders certified by OSFI should be separately posted. Finally, the Task Force is of the view that the Warning Circular should be given a much more prominent position at OSFI's Internet site. It should be updated regularly and include all foreign financial service providers believed to be operating in Canada either illegally or without a physical presence and without certification. The Canadian public should be actively encouraged to bring the names of any such entities to the attention of OSFI.

The lists of regulated financial institutions and certified lenders, and the Warning Circular, and the fact of their existence, should be given widespread exposure in different media.

Other Options

The Task Force looked at a number of other options aimed at protecting consumers with respect to foreign providers of financial services without a physical presence in Canada. Among them were legislated provisions deeming contracts with such providers to be made in Canada and to be governed by Canadian law, and enabling the Canadian consumer to sue in the Canadian courts should this become necessary. The conclusion was reached that any such measures are premature at this time. They cannot be implemented in a vacuum but should be studied as a part of the solutions that are needed in connection with electronic commerce as a whole. As stated earlier in this chapter under "Eventual International Regulation," the Task Force is also of the view that that regulation of these foreign financial firms needs to be developed not only in the context of electronic commerce as a whole but also in the context of international cooperation.

116 OSFI Web site: http://www.osfi-bsif.gc.ca/AndreE/Warning.htm.

Internet Fraud

The Criminal Code contains no special rules dealing with Internet fraud in the case of financial services or any other goods and services. The general definition of what constitutes fraud is extremely broad and sufficiently wide to cover fraud perpetrated over the Internet and to subject offenders to the applicable Criminal Code penalties including imprisonment. The difficulty is in locating the perpetrators, extraditing and charging them and bringing them to justice before the Canadian courts. While Canada has extradition treaties with various countries, this is not true in all cases. Even where such treaties are in force, there may be problems obtaining evidence due to certain evidentiary rules applicable in Canada but which are not recognized in the country concerned. Bill C-40[117], currently before Parliament, contains provisions which would allow the Canadian courts to accept evidence in the form required by the country to which a request for extradition has been made.

While there is nothing new in dishonest people defrauding consumers, in the new world of instantaneous transactions over the Internet, the scope for fraud involving financial services has expanded and the ease with which it can be carried out has increased. The Task Force urges that law enforcement authorities aggressively apply the existing provisions of the Criminal Code to fraud carried out over the Internet whenever possible, and that steps be taken to develop a harmonized approach at the international level to deal with what the Task Force believes will become an increasing problem.

First Steps Toward International Regulation

In November 1997, the OECD held an international conference in Finland on the subject of "Dismantling the Barriers to Global Electronic Commerce." While "finance and insurance" as topics were only discussed in passing, many of the more general conclusions reached applied to these sectors. Emphasis was placed on reducing "regulatory uncertainty in the new electronic environment," balanced by minimal government intervention, which should be "specific, precise and transparent."[118] The concept of "branding" or "accreditation" was introduced – in other words, a "seal of approval" for providers and products, which could be awarded by business or government or both. International cooperation in formulating rules was urged, as was the need for uniformity of rules across jurisdictions.

The suggestions that the Task Force is making with respect to certification of lenders and the right to use a logo indicating that such certification has been obtained is the first step toward this kind of accreditation.

[117] Bill C-40, An Act respecting extradition, to amend the Canada Evidence Act, the Criminal Code, the Immigration Act and the Mutual Legal Assistance in Criminal Matters Act and to amend and repeal other Acts in consequence, First reading May 5, 1998.

[118] Turku, Finland Report, *Dismantling the Barriers*. p. 1, 4.

Chapter 5

The Importance of International Standards and Coordination

Introduction

Background Paper #1, *Competition, Competitiveness and the Public Interest*, has commented on the globalization of the financial services sector and the changes that are being brought about by technology. The pace of change and globalization have been so rapid and the changes have been so extensive that there is a "growing mismatch between how firms run their businesses and how they are supervised," which has become a major new challenge.[119] Whereas supervisors have traditionally regulated particular types of financial firms, these institutional barriers are breaking down as companies move into new products and markets. Financial institutions are becoming increasingly internationalized with complex organizations and diversified operations spread across the globe and managed along business lines.

As a result, cooperation and coordination among regulators and supervisors, both at the level of individual countries and at the international level, have become increasingly vital to the proper monitoring of financial institutions. Equally important are the emergence and growth of international organizations and their influence in setting standards for both financial institutions and their supervisors.

Because of the important position that banks have traditionally held in national economies and financial systems, there is a long history of international consultation and cooperation on banking supervisory matters, going back to the creation of the Bank for International Settlements (BIS) in 1930. The BIS is a central banking institution owned and controlled by central banks with a board, comprising the governors of the central banks of the Group of Ten (G-10) countries, including Canada.[120] The BIS has become an important

[119] Report by G-7 Finance Ministers, *Financial Stability – Supervision of Global Financial Institutions*, May 1998, p. 1.

[120] The Group of Ten comprises Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom and the United States (there are 11 countries although the name remains "Group of Ten").

forum for international monetary and financial cooperation between central bankers and, increasingly, other regulators and supervisors.[121] As the importance of financial institutions other than banks has increased, and with the emergence of financial conglomerates the members of which represent different financial sectors, other international organizations focussed on insurance and securities have sprung up.

It is important to understand international developments in regulation because they provide a context for Canada's domestic regulatory system. The operation of our system, and changes that are proposed, need to be designed and implemented in a way that respects international cooperative efforts and contributes to them.

This chapter highlights some of the attempts at the international level to bring about a common approach to the regulation of financial institutions, and it outlines some of Canada's initiatives. The chapter covers some of the more significant initiatives to promote common standards and principles of supervision, as well as some of the methods of implementation and coordination.

International Standards and Principles

This section reviews recent international activity with regard to banks, insurance, securities, financial conglomerates, and governance.

Banks

The Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision is a committee of banking supervisory authorities established by the governors of the central banks of the G-10 countries in 1975 under the auspices of the BIS. The Committee provides a forum for regular cooperation between its member countries on banking supervisory matters. Although the Committee does not have any formal international supervisory authority and its conclusions do not have the force of law, it encourages convergence toward common standards and approaches to supervision by formulating broad supervisory standards and statements of best practice. These are implemented by individual regulatory authorities through statutory arrangements or otherwise, depending on the national system in question.

Canada is represented on the Committee by both OSFI and the Bank of Canada. The Committee has a structure of subgroups and task forces made up of technical experts from member countries. OSFI, which is represented on all the subgroups and task forces, participates actively in the supervisory gaps working group, the E-commerce working group, the credit derivatives working

[121] Bank for International Settlements, *Profile of an International Organization*, Basle, June 1998.

group, and the accounting task force. The accounting task force promotes international convergence in accounting and asset valuation practices, and is chaired by a Deputy Superintendent of OSFI.[122]

Some of the important contributions of the Basle Committee are described below.

Capital Adequacy and Risk Management

One of the Basle Committee's early and most important milestones has been the establishment of minimum capital standards and a framework for measuring capital adequacy. The 1988 Basle Capital Accord, which incorporated these standards, took a risk-weighted approach to capital adequacy.[123] The Capital Accord laid down the capital requirements for internationally active banks, based on relative levels of exposure to various forms of credit risk. The capital requirements are based on the concepts of:

- core capital (equity and disclosed reserves, or "Tier I Capital");
- supplementary capital (including undisclosed reserves, subordinated debt and hybrid capital instruments, or "Tier II Capital"); and
- risk-weighted assets. The minimum standard ratio of total capital to risk-weighted assets is set at 8 percent, and Tier I capital must account for at least 4 percent of risk-weighted assets. Although the Basle Committee has no enforcement powers, all the G-10 countries have adopted these standards and some have imposed higher minimum requirements.

The Capital Accord has been updated from time to time by the addition of rules regarding netting, the treatment of credit risk for derivatives and other off-balance-sheet instruments. An important revision was introduced in 1996 with the extension of capital requirements to market risk, including interest rate, equity, foreign exchange and commodity risk. For this purpose, a distinction was made between a bank's longer-term investments, to which the original credit risk weighting would be applied, and its trading book, to which the capital requirements for market risk would apply. The most recent amendment (April 1998) reduces the risk weight for claims on regulated securities firms.

Core Principles for Effective Banking Supervision

The Core Principles for Effective Banking Supervision were developed by the Basle Committee in conjunction with banking supervisors from both G-10

[122] Office of the Superintendent of Financial Institutions, *OSFI's International Participation and Reliance*, Submission to the Task Force on the Future of the Canadian Financial Services Sector, Ottawa, February 1998.

[123] The capital adequacy rules are informally known as the "BIS rules."

countries and non G-10 countries.[124] Described as the "single most important initiative of the Basle Committee"[125] in strengthening the financial sector in emerging market economies, the Core Principles consist of 25 minimum requirements considered essential for effective supervision. They were endorsed by the heads of government of the G-7 countries at the Birmingham meeting in May 1998.[126]

The Core Principles do not set out detailed rules and are designed to be flexible. They are intended to improve the strength of financial systems in both developed and developing countries, and in some cases may need to be strengthened or supplemented to deal with particular situations and risks arising in the financial systems of individual countries. Achieving consistency with the Core Principles will have a significant impact on improving financial stability both domestically and internationally. However, since many supervisory authorities at present do not have an adequate legal and administrative framework for implementation, the pace of achieving that consistency will vary.

The Core Principles are divided into seven groups as follows:

1) Preconditions for Effective Banking Supervision (Core Principle 1)

   These preconditions include a requirement for clear responsibilities and objectives for each supervisory agency, their operational independence and adequate resources to fund them. The legal framework must contain provisions relating to the authorization of banking organizations and banking supervisors, compliance, safety and soundness, and legal protection for supervisors. In addition, there must be arrangements for supervisors to share information and to protect the confidentiality of such information.

2) Licensing and Structure (Core Principles 2-5)

   These principles include:

   - clear delineation of the activities which banks are permitted to carry out, and control of the use of the word "bank" in names;
   - supervisory authority to set criteria with regard to ownership structure, directors and senior management, operating plans and internal controls, and major acquisitions or investment, and to review transfers of significant ownership or control in existing banks; and
   - assurance that corporate affiliations and structures do not expose the bank to undue risk or hinder supervision.

124 Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Basle, September 1997).

125 Submission by the Basle Committee for the G-7 Heads of Government, *Promoting Financial Stability: Recent Initiatives of the Basle Committee on Banking Supervision* (Basle, March 1998), p. 3.

126 G-7 Chairman's Statement, May 15, 1998. The G-7 countries are the United States, the United Kingdom, France, Germany, Japan, Canada and Italy.

3) Prudential Regulation and Requirements (Core Principles 6-15)

The Core Principles under this heading include capital adequacy requirements, which, for internationally active banks should, at the minimum, be those established by the Basle Capital Accord. The policies, practices and procedures of banks with respect to items such as loans, investments, control of market and other risks and "know your customer" rules must be evaluated and adhered to. Adequate related-party rules must be in place.

4) Methods of Ongoing Banking Supervision (Core Principles 16-20)

Effective bank supervision should include both on-site and off-site supervision and regular contact with management. Systems must be in place to collect, review and analyse information, which should be independently validated either by examinations or through external auditors. Supervision of the banking group on a consolidated basis is essential.

5) Information Requirements (Core Principle 21)

This principle stresses the importance of maintenance of adequate records by banks and the regular publication of financial statements. Records and statements should be drawn up in accordance with consistent accounting principles, enabling the supervisor to obtain an accurate picture of the condition and profitability of the bank.

6) Formal Powers of Supervisors (Core Principle 22)

Banking supervisors must have adequate powers to impose corrective measures for regulatory violations and failure to meet prudential requirements. These should include the ability to revoke the licence of the bank concerned.

7) Cross-border Banking (Core Principles 23-25)

Internationally active banking organizations must be supervised on a global, consolidated basis by the home supervisor, including supervision of their foreign branches, joint ventures and subsidiaries. This involves establishing contact and information exchange with other supervisors involved, primarily those in the host country. Conversely, the local operations of foreign banks should be conducted to the same standards required of domestic institutions. Supervisors must have the power to share information which may be required by the home country supervisor for the purposes of consolidated supervision.

The Basle Committee is in the process of assessing the state of global implementation of the Core Principles and identifying areas where further work is needed to enable non-G-10 countries to fully comply.[127]

[127] Basle Committee G-7 Submission, March 1998.

Supervision of Cross-border Banking

Supervision of cross-border banking was one of the first subjects tackled by the Basle Committee.[128] The Basle Concordat, published in 1983 and revised several times, set out the principles governing the supervision of banks' foreign establishments, whether branches, subsidiaries or joint ventures. The key principles were that no foreign banking establishment should escape supervision and that supervision should be adequate. Effective cooperation between host and parent authorities, including exchange of information, was cited as the essential prerequisite to these principles. The subject of information flows between banking supervisory authorities was the subject of a Supplement to the Concordat, published in 1990. It made a number of recommendations with regard to contact and collaboration between host and parent supervisors.

In 1992, certain principles of the Concordat were reformulated into four Minimum Standards, as follows:

1) All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision. This is a precondition for the creation and maintenance of a cross-border banking establishment, and must be ascertained by the host country authority.
2) The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisor and the home country supervisor of the bank and, if different, the home country supervisor of the banking group.
3) The home country supervisor of banks or banking groups with cross-border banking establishments should have the right to obtain information from such foreign establishments. This should be accomplished through bilateral agreements or mutual understandings between the supervisors in different countries. Such agreements and understandings would be to the effect that the home country supervisor will be entitled to gather information from cross-border establishments located in the other supervisor's jurisdiction.
4) In the event that a host country supervisor determines that any of the foregoing minimum standards are not met to its satisfaction, restrictive measures should be imposed to satisfy its prudential concerns. These measures may include prohibiting the creation of the banking establishment in question.[129]

[128] The supervision of cross-border banking is also referred to in Principles 23, 24 and 25 of the *Core Principles for Effective Banking Supervision* (see above).

[129] Basle Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishment* (Basle, July 1992).

Subsequently, a number of problems in implementing the Minimum Standards came to light. These fell into two broad categories: difficulties with access to information and difficulties in judging what constitutes effective home and host supervision. A working group consisting of members of the Basle Committee and the Offshore Group of Banking Supervisors issued a report in 1996 containing a number of recommendations for overcoming these impediments.[130]

Insurance

The International Association of Insurance Supervisors

The International Association of Insurance Supervisors (IAIS) is a forum for approximately 90 insurance regulators from over 70 countries. It was established in 1992 in recognition of the fact that insurance industries and markets "are of fundamental economic importance, nationally and internationally and that most domestic insurance markets are increasingly being integrated into a global market."[131] The work of the IAIS parallels the initiatives of the Canadian Council of Insurance Regulators to achieve consensus on general supervisory principles for both domestic and cross-border operations.

OSFI has participated since 1993. In September 1997, a Deputy Superintendent of OSFI was elected Chair of the IAIS Executive Committee, and OSFI also chairs the Derivatives Subcommittee.

OSFI's influence at the IAIS is extensive. This is due in part to the fact that there is no dominant U.S. player at the IAIS as a result of the fragmented nature of U.S. insurance regulation, and in part to OSFI's leadership and the quality of OSFI's technical work. The fact that OSFI's banking and insurance supervisory policy staff work closely together has enabled OSFI participants to play a key role.[132]

As is the case with the Basle Committee, the IAIS has no formal supervisory role and its conclusions are not legally binding. Members are encouraged to implement standards and principles arrived at by the IAIS in whatever way is appropriate for the country concerned. The IAIS recently published two papers on insurance standards with similarities to the work of the Basle Committee. It is intended that the adoption of the principles contained in the papers will strengthen prudential supervision of insurance and facilitate cooperation among regulators. The principles are outlined below.

[130] Report of the working group of the Basle Committee and the Offshore Group of Banking Supervisors, *The Supervision of Cross-Border Banking* (October 1996).

[131] International Association of Insurance Supervisors Web site, http://www.naic.org/otherinf/iais/about.htm, "About the IAIS," July 1998.

[132] A more extensive description of OSFI's role in the IAIS can be found in *OSFI's International Participation and Reliance*, p. 9.

Insurance Supervisory Principles

Not surprisingly, in an era of convergence of functions and conglomeration of institutions, the paper on "Insurance Supervisory Principles" is similar to the "Core Principles for Effective Banking Supervision" of the Basle Committee. Its main points are as follows:[133]

- Companies writing insurance should be licensed and monitored.
- Insurance supervisors should assess the suitability of owners, directors and senior management.
- Initial assessment and monitoring should take into account business plans, financial statements, capital plan and solvency margins.
- Ongoing supervision should include the following:
  - responsible corporate governance;
  - prudential rules;
  - risk management;
  - on-site inspections;
  - sanctions for violations; and
  - coordination between insurance supervisors where appropriate.

The IAIS has also issued a set of guidelines for insurance supervisors in emerging markets to assist them in complying with the Insurance Supervisory Principles.

The Insurance Concordat

The Insurance Concordat deals with cross-border establishments and parallels the Basle Committee's Concordat on supervision of cross-border banking. Its main points are the following:[134]

- No foreign insurance establishment should escape supervision.
- All insurance establishments of international insurance groups and international insurers should be subject to effective supervision.
- Consultation between the home and host supervisors should take place prior to the creation of a cross-border insurance establishment.

Securities

The International Organization of Securities Commissions

The International Organization of Securities Commissions (IOSCO) has 134 member agencies and its General Secretariat is located in Montreal. OSFI is not formally represented since it does not have jurisdiction over securities, which

133 International Association of Insurance Supervisors, press release, September 3, 1997.

134 Ibid.

is a provincial matter. However, both the Ontario Securities Commission (OSC) and the Commission des valeurs mobilières du Québec (CVMQ) are members; the Alberta Securities Commission and the British Columbia Securities Commission are associate members; and the Investment Dealers Association of Canada and the Vancouver Stock Exchange are affiliate members. The chairs of the OSC and the CVMQ alternate as members of the Executive Committee of IOSCO.

IOSCO's objectives are to foster (1) cooperation among its members in order to promote high standards of securities regulation; (2) the exchange of information; and (3) the establishment of standards and effective surveillance of international securities transactions. The members meet at an annual conference, and various committees meet more frequently. These include a technical committee, which looks at multinational disclosure and accounting, regulation of secondary markets and market intermediaries, enforcement, the exchange of information, and investment management. The emerging market committee promotes the development and efficiency of emerging securities markets and, in this context, addresses similar areas to those of the technical committee.

Financial Conglomerates

The Tripartite Group

The Tripartite Group, consisting of bank, securities and insurance regulators, was set up in specific response to the changes taking place in financial services that have led to the formation of conglomerates active across national borders. It was formed at the initiative of the Basle Committee in 1993 to address a range of issues relating to the supervision of financial conglomerates from a cross-industry perspective. In July 1995, the Tripartite Group issued a report entitled *The Supervision of Financial Conglomerates*,[135] which was sent to the Basle Committee, the IAIS and IOSCO. While the issues that the supervision of financial conglomerates poses had been examined separately by bank, securities and insurance regulators, the report represented the first time that the issues had been addressed by three sets of supervisors working together.

For working purposes, the Tripartite Group defined "financial conglomerate" as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)."[136] While the report recognized that many of the problems encountered also arise in the context of

[135] Report of the Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates* (July 1995).

[136] Ibid, p. 13.

supervising "mixed conglomerates" (i.e., those engaged in both financial and commercial activities), the report focussed on financial conglomerates.

The report drew attention to three main areas. First, in relation to capital adequacy, the Tripartite Group concluded that a group-wide perspective could be achieved by adopting either a consolidated type of supervision traditionally used by bank supervisors, or a "solo plus" approach, in which the supervision of individual entities is complemented by a general qualitative assessment of the group as a whole. Second, the report stressed the need for "intensive cooperation between supervisors responsible for different entities within a conglomerate and the necessary exchange of prudential information."[137] General support was given to the idea of appointing a lead supervisor who would be responsible for gathering information required by the individual supervisors in order for them to gain perspective on the risks assumed by the group as a whole. The third area addressed was the concern that complex group structures can impede supervision. The report expressed the view that supervisors require powers to obtain adequate information with respect to legal and managerial structures. If necessary, supervisors should be given powers to prohibit structures which impair adequate supervision.

In addition, the report also addressed issues such as contagion (particularly the effects of intra-group exposure), large exposures at a group level, problems in applying a suitability test to shareholders and a fit and proper test to managers, rights of access to information about non-regulated entities within a conglomerate, supervisory arbitrage, and the particular problems of mixed conglomerates engaged in both financial and non-financial activities.

The Joint Forum on Financial Conglomerates

One outcome of the report of the Tripartite Group was the establishment in 1996 of the Joint Forum on Financial Conglomerates by the Basle Committee, IAIS and IOSCO (collectively the "parent organizations"). The Joint Forum is made up of an equal number of senior bank, insurance and securities supervisors, with representation from 13 countries including Canada. Canada is represented at the Joint Forum by OSFI and by the Ontario Securities Commission (an IOSCO member).

The purpose of the Joint Forum is to examine supervisory issues relating to financial conglomerates and to develop practical working arrangements among their different supervisors, for consideration by the parent organizations and their members. Its focus has been primarily on diversified financial firms with large-scale activities crossing national borders and sectoral boundaries. However, the Joint Forum is of the opinion that its findings and recommendations

[137] Tripartite Group, *The Supervision of Financial Conglomerates*, p. 2.

could also apply to smaller conglomerates or conglomerates that operate within national boundaries.

Draft papers on the supervision of financial conglomerates have been prepared by the Joint Forum and distributed to the parent organizations for consultation. These papers were released by the parent organizations in February 1998, and feedback invited.[138] They are:

- *Capital Adequacy Principles.* This paper outlines various measurement techniques and guiding principles for the assessment of capital adequacy on a group-wide basis for financial conglomerates. The paper does not promote any single technique, but explores a number of existing approaches by various supervisors that should result in broadly equivalent assessments.
- *Fit and Proper Principles.* This paper recognizes that integrity and competence are critical factors in the top management of banks, insurance companies and securities firms. It provides guidance to supervisors of entities within a financial conglomerate for assessing whether those entities are soundly and prudently managed. The paper also promotes arrangements to facilitate the exchange of information between supervisors with respect to both individuals and entities.

The Joint Forum consultation papers also include drafts on the topics of supervisory information sharing and supervisory coordination, described in more detail later in this paper under "Implementation and Coordination."

OSFI participated in the working group on capital adequacy, and although these techniques are still being tested, it anticipates that they will become the international standard for evaluating conglomerates, including several Canadian banks and insurance companies.[139] The Joint Forum is undertaking consultations on the draft papers with the aim of finalizing them in the fall of 1998. Upon ratification by the Basle Committee, IAIS and IOSCO (expected by the spring of 1999), the principles elaborated will apply to all regulators participating in the three parent organizations.

Governance

Corporate governance and effective internal controls are critical for the sound management and operation of financial institutions. Governance and internal controls are important in ensuring that business objectives and profitability targets are met. But they are equally important in ensuring reliable and consistent financial and managerial reporting, and compliance both with laws and regulations and with internal policies and procedures. Supervisors around the

138 Joint Forum on Financial Conglomerates, *Supervision of Financial Conglomerates*, February 1998.

139 *OSFI's International Participation and Reliance*, p. 10.

world are increasingly focussed on evaluating governance and internal controls. Inadequate board and management oversight, failure to develop a strong control culture, and lack of accountability are consistent elements in major losses by banks and other financial institutions.

In this context, the Basle Committee issued a draft paper in January 1998, entitled "Framework for the Evaluation of Internal Control Systems."[140] The Framework clarifies the role and responsibilities of boards of directors and senior management; it is intended to be used by supervisory authorities in assessing methods and procedures for monitoring the way in which banks structure their internal control systems. Unlike many of the papers issued by the Basle Committee, the Framework does not focus on specific areas or activities but takes a more general approach in describing organizational structures that will promote strong corporate governance.

The Framework contains 14 "Principles for the Assessment of Internal Control Systems," under six headings as follows:

1) Management Oversight and the Control Culture (Principles 1-3)

   These principles include the following:

   - The board of directors should be responsible for approving strategy, policy and organizational structure, setting acceptable levels for risks, and ensuring their identification, monitoring and control by senior management.
   - Senior management should be responsible for implementing board strategies, setting internal control policies and monitoring their effectiveness.
   - Both the board and senior management should have responsibility for promoting high standards of ethics and integrity, and for establishing a corporate culture that emphasizes the importance of internal controls.

2) Risk Assessment (Principles 4, 5)

   Senior management should ensure that all internal and external factors and risks that could adversely affect the bank are continually being identified and evaluated.[141]

3) Control Activities (Principles 6, 7)

   Senior management must set up appropriate control structures to ensure effective internal controls at every business level, including top-level review, activity controls for different departments, physical controls, periodic compliance checks for exposure limits, and systems for approvals and authorizations and

140 Basle Committee on Banking Supervision, *Framework for the Evaluation of Internal Control Systems*, (Basle, January 1998).

141 Risks include credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and risk to reputation. Ibid., p. 3.

for verification and reconciliation. There must be an appropriate segregation of duties so that personnel are not assigned conflicting responsibilities.

4) Information and Communication (Principles 8-10)

Senior management should have responsibility for ensuring that adequate and comprehensive internal financial, operational and compliance data and external market information relevant to decision making are available on a reliable, timely and accessible basis and in a consistent format. Staff should be made aware of all relevant information through effective and secure channels of communication and information systems, which should be periodically tested.

5) Monitoring (Principles 11-13)

Senior management should continually monitor the overall effectiveness of the bank's internal controls; key risk monitoring should be part of daily operations. Comprehensive internal auditing of the control system should be carried out, with the internal audit function reporting directly to the board or its audit committee and to senior management. Deficiencies should be reported and addressed promptly.

6) Evaluation of Internal Control Systems by Supervisory Authorities (Principle 14)

Supervisors should require all banks to have an effective system of internal controls consistent with the nature, complexity and risk of their on-and off-balance sheet activities that is responsive to changes in conditions. Where supervisors determine that an internal control system is inadequate (for example, because it does not cover all the Principles), immediate action should be taken to ensure that the system is improved.

The Framework is based on current practices in place at major banks, securities firms and non-financial companies. Supervisors are instructed to determine that the internal control process is effective across all business lines and subsidiaries within a consolidated banking organization.

Other international organizations are also looking closely at governance and controls (for example, the "Fit and Proper" consultation paper of the Joint Forum, mentioned earlier).

Implementation and Coordination

One effect of the globalization of the financial sector and the emergence of international financial conglomerates has been that effective supervision has become increasingly dependent on information flows and cooperation between supervisors, both within countries and across borders. Information provided by financial institutions in different sectors and different countries needs to be consistent

in order for supervisors to make proper evaluations on a consolidated basis, and supervisors themselves require a high level of skill and competence. A number of initiatives have been undertaken at the international level in these areas.

Training and Assistance

Both the International Monetary Fund (IMF) and the World Bank have a role in providing training and technical assistance to developing countries. Technical assistance provided by the IMF relates primarily to building the financial infrastructure through advising on central banking and the design and development of monetary, foreign exchange and public debt markets, instruments and payments systems. Training is also provided to country officials in support of technical assistance in these areas. The World Bank is involved in building the financial infrastructure through strengthening regulation and supervision, strengthening auditing and accounting, establishing legal frameworks, and restructuring banks through privatization, recapitalization and financial restructuring. The Bank offers policy advice in all these areas and provides training for bank supervisors and bankers.

The Basle Committee provides technical assistance for supervisory authorities of both G-10 and non-G-10 countries and collaborates with the IMF, the World Bank and other organizations in providing training for bank supervisors. In a joint initiative with the BIS, the Committee recently established the Institute for Financial Stability. The Institute will organize high-level seminars for key policy-making officials of central banks and supervisory agencies. It will provide advanced training and assistance in policy implementation for groups of senior officials, and will act as a clearing house for the coordination and provision of technical assistance by central banks and supervisory authorities. An early focus will be guidance in the practical implementation of the Core Principles, in conjunction with officials from emerging market countries.

The IAIS holds regional training sessions for insurance supervisors and has arranged for the World Bank to help in dissemination of IAIS standards and to provide financial support to members wishing to attend training seminars.

The Toronto Centre

The World Bank announced in September 1997 that together with the Government of Canada, and with the support of OSFI and the Schulich School of Business at York University, it would jointly sponsor the creation of what is now known as the Toronto International Centre for Leadership in Financial Sector Supervision. The purpose of the Toronto Centre is to assist developing countries in improving their systems of banking and insurance supervision, and to provide practical leadership training for supervisors to help them implement effective supervisory regimes in their own countries.

Information Sharing and Coordination

The success of many initiatives at the international level depends on flows of information among the supervisors of different countries, and the ability of supervisors to access information about the cross-border activities of the financial institutions and financial groups of which they are the home country supervisors. Examples of situations where such information sharing is essential are found in the Core Principles, the Basle Concordat and the Insurance Concordat, described earlier in this chapter. A number of reports and papers have detailed problems relating to access to, and exchanges of, information, and have made various recommendations.[142] Nevertheless, this is an area where many problems remain, including constraints on the ability of regulators to disclose information to supervisory colleagues, both in their own countries and abroad, and the need to keep such information confidential.

The 1998 Report by the G-7 Finance Ministers highlighted the key issues relating to information exchange which have been identified by the Joint Forum. These key issues include:

- a lack of general statutory authority for supervisors to exchange confidential regulatory information, both cross-sectorally and internationally;
- restrictions in legislation limiting exchanges of information to specified supervisors for specified purposes;
- the need to maintain the confidentiality of information exchanged; and
- requirements for formal agreements before information can be shared.[143]

As a result, the G-7 Finance Ministers adopted 10 key principles for removing barriers to information exchange and stated that where necessary, statutory authority should be provided. The principles are summarized below:

1) *Sharing and gathering information.* Authority for a supervisor to share information with foreign supervisors both in response to requests and when the supervisor considers it would be beneficial; includes adequate power for the supervisor to both gather and exchange information without seeking permission.

142 These include *Information Flows Between Banking Supervisory Authorities*, Basle Committee, April 1990; *Exchanges of Information between Banking and Securities Supervisors*, Basle Committee, April 1990; the Basle/IOSCO Joint Statement for the Lyon Summit, May 1996; and the report of the working group comprising members of the Basle Committee and the Offshore Group of Banking Supervisors, *The Supervision of Cross-Border Banking*, Part III, entitled "Improving the Access of Home Supervisors to Information Necessary for Effective Consolidated Supervision", October 1996.

143 1998 G-7 Finance Ministers' Report, *Financial Stability*, Annex A.

2) *Cross-sector information sharing.* Authority for a supervisor to share information with the supervisors of different financial service sectors both domestically and internationally.
3) *Systems and controls information.* Cooperation among supervisors in identifying and monitoring management and information systems and controls by international firms
4) *Information about individuals.* Authority for a supervisor to share objective information of supervisory interest about individuals such as owners, shareholders, directors and managers.
5) *Information sharing between exchanges.* Authority for exchanges in one jurisdiction to share information with exchanges in other jurisdictions.
6) *Confidentiality.* Supervisors providing information should be able to require that the supervisor receiving the information maintain its confidentiality, but should not seek to limit its use for supervisory purposes.
7) *Formal agreements and written requests.* These should not be obligatory, although memorandums of understanding may be useful, as may requests in writing setting out the details of the information required.
8) *Reciprocity requirements.* These should not be a strict precondition for sharing information, particularly in an emergency situation, although reciprocity may be useful in encouraging information exchanges.
9) *Passing received information on to other supervisors.* A supervisor receiving information should be permitted to pass it on to other supervisors in its jurisdiction.
10) *Removal of laws preventing exchange of information.* Each jurisdiction should take steps to remove laws and procedures that hamper the exchange of information among supervisors.

The G-7 Finance Ministers committed to making changes to their own regimes to bring them in line with the key principles.

Other initiatives to increase information sharing have been taken by the Joint Forum in two of the consultation papers contained in the *Supervision of Financial Conglomerates.*[144] The first of these papers, *Framework for Supervisory Information Sharing*, outlines a framework for facilitating information sharing between supervisors of regulated entities that are part of international financial conglomerates. The framework is based on a "mapping" project carried out by the Joint Forum to analyse the structure and operation of several

[144] See earlier section on "The Joint Forum on Financial Conglomerates."

financial conglomerates in order to better understand how they are managed and supervised. OSFI took part in this exercise by mapping a major Canadian banking conglomerate. The findings highlighted the fact that many international conglomerates are managed along product lines that cut across legal and national boundaries, posing challenges to supervisors whose authority is limited to domestic entities. Another dimension with implications for supervision is the organization of corporate control functions on a globalized or centralized basis.

The second paper, *Principles for Supervisory Information Sharing*, sets out a number of guiding principles to enhance information-sharing arrangements among supervisors. The paper recognizes that the information needs of supervisors will vary depending on many different factors, including both the organizational structures of particular financial conglomerates and the approach and objectives of the supervisor in question.[145] A third paper, entitled *Coordinator Paper*, provides guidance for the identification of a supervisory coordinator or coordinators, and catalogues elements of coordination from which supervisors can select the role and responsibilities of a coordinator in both emergency and non-emergency situations.

The IAIS has published a draft Memorandum of Understanding that could be used by supervisors in improving the exchange of information.

Transparency

The IMF has developed both the Special Data Dissemination Standards (SDDS) and the General Data Dissemination System (GDDS). The SDDS was established in 1996 to guide countries that have, or that might seek, access to international capital markets in the dissemination of economic and financial data to the public. It attempts to institute internationally comparable measures in areas such as reserves, the external exposure of financial sectors, and indicators of financial sector stability. The May 1998 Report of the G-7 Finance Ministers urged the IMF to encourage its members to subscribe to the SDDS and to publicize failures to meet the standards.[146] The GDDS was established in 1997 to guide countries in the provision to the public of comprehensive, timely, accessible and reliable economic, financial and socio-demographic data. Adherence to the SDDS and the GDDS will enhance the quality of information exchanged among supervisors.

[145] Explanatory note issued with a press release of the Basle Committee on Banking Supervision, February 19, 1998.

[146] Report of the G-7 Finance Ministers to the Heads of State or Government, *Strengthening the Architecture of the Global Financial System*, Birmingham, May 1998, paras. 7, 8.

The BIS is working with national authorities to improve the quality of data on the level of external bank exposure, and to speed up its collection and publication. The Report of the G-7 Finance Ministers noted the need for countries to provide more qualitative descriptive information on their financial systems, markets, institutions, laws and other aspects of their financial sectors. This information should include details of banking supervision, bankruptcy procedures, the "credit culture," skills and structure of the banking sector, and the relationship among banks, government and the industrial sector. Consideration needs to be given, in conjunction with international financial institutions, to the question of who should collect this information and how it should be published.[147]

Enhanced Surveillance

Both the IMF and the World Bank are involved in the surveillance of financial sector activities. The IMF is primarily involved in identifying vulnerabilities in financial systems that might have major macro-economic implications, and in promoting the implementation of policy frameworks for the financial sector that are consistent with internationally acceptable standards. It is also involved in identifying deficiencies in international financial supervision and regulation, and suggesting corrective policies. The World Bank assesses the conditions of countries' financial sectors as an outcome of its role in building the infrastructure of financial sectors. These services are delivered through the Bank's lending operations, technical assistance and policy advice.

Canada has been a proponent of enhanced international surveillance for some time.[148] Canada's Minister of Finance presented a proposal to the G-7 in April 1998 to establish a new international secretariat to survey financial supervisory systems and identify financial sector problems before they become international crises. Recent events such as the turmoil in Asia demonstrate that national financial sector problems can spread internationally. "In this increasingly interdependent world, all nations must take proactive steps to ensure stability at home and internationally."[149]

The enhanced surveillance mechanism would be based on the principle of peer review. There would be no new bureaucracy. The proposed secretariat would pool supervisory resources within individual countries and existing international institutions in order to review financial supervisory and regulatory regimes in participating countries. The review would apply on a rotating basis. Initially, participation would not be mandatory but it is hoped that eventually

147 1998 Report of G-7 Finance Ministers, *Strengthening the Architecture*, para. 7.

148 Prime Minister Jean Chrétien noted the international need for transparency and enhanced surveillance internationally at the G-7 Summit in Halifax in 1995; see also Department of Finance Canada, press release, "International Supervisory and Surveillance Initiative Proposed," April 15, 1998.

149 Ibid., press release.

all countries would take part. A summary of the surveillance review would be made public, with the additional benefit of providing potential investors with better information.

The May 1998 Report of the G-7 Finance Ministers stated that there is an "urgent need for a system of multilateral surveillance of national financial, supervisory and regulatory systems."[150] This could encompass surveillance of banking and securities supervision, corporate governance, accounting, disclosure and bankruptcy. The relevant international institutions have been asked to develop proposals on ways in which greater cooperation could be achieved.

Electronic Financial Services

New technologies that have resulted in the advent of electronic commerce – including electronic banking, electronic money and the provision of other financial services through electronic means – have significant implications for consumers, financial institutions and supervisory authorities alike. The full impact of these developments, both their benefits and their risks, remains unknown. As a result, both domestic supervisors and international organizations have been cautious in laying down hard and fast rules in this area. However, a number of initial assessments and reviews have been undertaken by international organizations.

Group of Ten

The G-10 working party on electronic money published a report on the subject in April 1997.[151] The working group comprised representatives from finance ministries, central banks and international organizations, and consulted with law enforcement agencies. The primary objectives of the report were to develop a broader understanding of the policy issues facing governments as a result of the development and use of retail electronic payment systems, and to identify issues that could benefit from international cooperative efforts. On the issue of consumer protection, the report noted that most countries continue to rely on existing laws and regulations in addressing concerns such as loss, fraud and privacy, rather than enacting comprehensive new measures, and that government policies on consumer protection are still evolving in tandem with developments in technology.

150 Report of G-7 Finance Ministers, *Strengthening the Architecture of the Global Financial System*, para. 17.

151 Group of Ten, *Electronic Money: Consumer protection, law enforcement, supervisory and cross border issues*, Basle, April 1997.

OECD

Many of the more general conclusions reached at the OECD conference in Finland in November 1997 applied to finance and insurance. Emphasis was placed on reducing regulatory uncertainty, balanced by minimal government intervention. The concept of "branding" or "accreditation" (discussed in Chapter 4) was introduced. International cooperation in formulating rules was urged, and the need for uniformity of rules across jurisdictions was underlined. Another constant theme was the need for international standards of privacy and confidentiality of information.

The Basle Committee

In March 1998, the Basle Committee published a paper entitled *Risk Management for Electronic Banking and Electronic Money Activities*. The Committee noted that the paper was an initial step in an ongoing review and discussion of supervisory issues and responses related to technological advances in electronic banking and electronic money. It also stressed the importance for supervisory authorities to avoid policies "that hamper useful innovation and experimentation," and emphasized that many aspects of risks are not fully discernible or easily measured.[152] The paper set forth some definitions of electronic banking and electronic money, referred to the key role that banks can play as participants in electronic money activities, and identified some of the risks that banks may face. The discussion of risks is described as not exhaustive and intended to be illustrative of the types of problems that may arise, including operational, reputational and legal risks.

Conclusion

The trend toward complex international financial conglomerates with product lines cutting across the traditional financial sectors, across national boundaries and across legal and supervisory systems has heightened an urgent need for internationally accepted standards and for cooperation and information sharing among supervisors. While progress has been made, much remains to be done. Canada has been an active, effective and respected participant in the processes of international organizations such as the Basle Committee, the IAIS and the Joint Forum, and is playing a leadership role through the establishment of the Toronto Centre and the initiative for enhanced surveillance. The Task Force endorses Canada's leadership in this regard and urges that Canada continue to give priority to developing international standards and coordination. Changes to financial sector legislation, including the implementation of proposals made by the Task Force, should be made in light of the emerging international framework.

152 Basle Committee on Banking Supervision, *Risk Management for Electronic Banking and Electronic Money Activities* (Basle, March 1998), summary.